Supreme Court, U.S.
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No. 06-

IN THE

Supreme Court of the United States

LANCO, INC.,

Petitioner,

v.

DIRECTOR, DIVISION OF TAXATION,

Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of New Jersey

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the Supreme Court of New Jersey erred when it concluded – expressly acknowledging a split among the States on the question – that the Commerce Clause of Art. I, § 8, permits a State to impose an income tax on an out-of-state corporation that has no physical presence in the taxing State.

RULE 29.6 STATEMENT

Petitioner Lanco, Inc. was a wholly owned subsidiary of Limited Brands, Inc., a publicly-held company, during the fiscal year ending January 31, 1998, the tax period involved in this dispute. Petitioner was sold on August 16, 2001, to Venice Acquisition Corporation, a subsidiary of Charming Shoppes, Inc., a publicly-held company, after which it became a subsidiary of Charming Shoppes, Inc.; Limited Brands, Inc., however, agreed to indemnify the purchaser for liabilities related to pre-closing tax periods. Petitioner was merged into another subsidiary of Charming Shoppes, Inc., on April 29, 2005.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner respectfully seeks this Court's review of the judgment of the Supreme Court of New Jersey.

OPINIONS BELOW

The opinion of the Supreme Court of New Jersey (Petition Appendix ("App.") 1a-3a) is reported at 908 A.2d 176. The decision of the Appellate Division of the Superior Court of New Jersey (App. 4a-20a) is reported at 879 A.2d 1234. The decision of the New Jersey Tax Court (App. 21a-42a) is reported at 21 N.J. Tax 200.

JURISDICTION

The judgment of the Supreme Court of New Jersey was entered on October 12, 2006 (App. 1a). On December 22, 2006, Justice Souter extended the time for filing this Petition to and including February 9, 2007. On January 26, 2007, Justice Souter again extended the time for filing this Petition to and including March 9, 2007. This Court has jurisdiction under 28 U.S.C. § 1257(a).

CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. Art. I, § 8, cl. 3, provides: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

The relevant New Jersey statutory and regulatory provisions are set forth at App. 43a - 50a.

INTRODUCTION

This Petition presents the question whether the Commerce Clause permits States to impose income and franchise taxes on an out-of-state entity with no in-state physical presence. This is a question of enormous practical importance on which the States are squarely in conflict.

Forty years ago in its seminal decision in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 754 (1967), this Court confirmed the longstanding rule that a State imposes an unconstitutional burden on interstate commerce when it attempts to force tax collection and remittance responsibilities on an out-of-state entity that lacks any "physical presence in the taxing State." *Quill Corp. v. North Dakota*, 504 U.S. 298, 314 (1992). Subsequently, in 1977, in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), this Court adopted a general test for dormant Commerce Clause challenges to the exercise of state taxing power, deciding in relevant part that, in the absence of congressional action, the Commerce Clause permits taxation of out-of-state businesses only where, *inter alia*, the tax "is applied to an activity with a substantial nexus with the taxing State." *Id.* at 279. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Court applied this test in the context of sales and use taxes and reaffirmed *Bellas Hess*, holding that an out-of-state corporation has a "substantial nexus" with the State for purposes of such taxes only where the corporation has a "physical presence" in the taxing State. *Id.* at 314.[1]

Consistent with the decisions of this Court, "courts traditionally have regarded a corporation's physical presence in a state as necessary to establish jurisdiction to subject that corporation to income taxation in the state." J. Hellerstein & W. Hellerstein, State and Local Taxation 386 (8th ed. 2005).

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[1] The phrase "physical presence" as it is used in both *Quill* and this Petition is a term of art including not only maintenance of an office, ownership of real property, or maintenance of employees in-state, but also the conduct of certain "activities performed in . . . state on behalf of the taxpayer," for example, the solicitation of orders for sales by independent contractors. *See Tyler Pipe Indus. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 250 (1987) (internal quotation marks and citation omitted); *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960); *Quill*, 504 U.S. at 306 (cataloguing the cases and explaining that "all involved some sort of physical presence within the state").

Indeed, while both *Bellas Hess* and *Quill* involved state sales and use taxes, neither before *Complete Auto* nor after has this Court ever upheld the imposition of *any* state tax on an out-of-state entity in the absence of some physical presence in the taxing State. This makes sense: This Court has made clear that the relevant question in distinguishing tax statutes for purposes of Commerce Clause analysis is whether they have the same effect. "[D]ifferently denominated tax[es]" that operate in the same way will be treated identically. *Quill*, 504 U.S. at 310; *see Complete Auto*, 430 U.S. at 284 (noting that a gross receipts tax can be reworded as a franchise tax on intangible property in the form of "going concern" value, but that there would be "no real economic difference between the statutes"). In the forty years since *Bellas Hess*, Congress – which "has the final say over regulation of interstate commerce[] and . . . can change the rule of *Bellas Hess* simply by saying so," *Quill*, 504 U.S. at 320 (Scalia. J. concurring in part and concurring in the judgment) – has never acted to eliminate or modify the physical-presence rule. Indeed, Congress has repeatedly rejected attempts to permit the States broader authority to tax out-of-state entities that engage in interstate commerce. *See, e.g.*, S. 2152, 109th Cong. (2005), S. 2153, 109th Cong. (2005), S. 1736, 108th Cong. (2003), H.R. 3184, 108th Cong. (2003).

Nonetheless, at about the time *Quill* was decided, the taxing authorities in a number of States seeking new ways to obtain revenue from out-of-state taxpayers began imposing corporate income and franchise taxes on out-of-state businesses whose sole contact with the State was sales to in-state customers. States have tried to tax any business operating anywhere in the nation, pursuing music publishers because their songs are available on the radio to in-state listeners; cable TV producers because their programs are available to in-state viewers; and licensors of computer software because

their intangible products are being "used" in a State.[2] State courts have increasingly sanctioned the unprecedented imposition of such income and franchise taxes. To avoid the force of *Bellas Hess* and *Quill*, these courts have held that physical presence is required *only* for the imposition of sales and use taxes, and not for income, franchise, and other types of business operation taxes. App. 3a.

The first case ever to hold that "the taxpayer need not have a tangible, physical presence in a state for income to be taxable there" was *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13, 18 (S.C. 1993). The *Geoffrey* case generated "an enormous outpouring of commentary." *See* Hellerstein and Hellerstein, *supra*, at 394. It also led to a direct conflict in authority among the States about the permissible scope under the Commerce Clause of state authority to tax out-of-state corporations engaged in interstate commerce. In several States, courts have retained the traditional physical presence rule under the Commerce Clause. *See infra* at 9-12. In other States, the courts – including now the New Jersey Supreme Court below – have followed *Geof-*

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[2] *See, e.g.*, 2006 Survey of State Tax Departments, (BNA). Vol. 13, No. 4 at S-20-21 (April 28, 2006), available at http://www.bna.com/states/statesurvey/2006survey.pdf (last visited March 5, 2007) (24 States and the District of Columbia indicated that they would assert nexus over a company for purposes of income taxes if the company licenses standard software for use in their jurisdiction); Multistate Tax Commission, Model Statute, Factor Presence Nexus Standard for Activity Taxes (Oct. 17, 2002), available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf (last visited March 5, 2007) (nexus established if sales threshold exceeded, includes sales of intangible and digital products); *Business Activity Tax Simplification Act of 2003: Hearing Before the Subcomm. on Commercial & Administrative Law of The House Comm. on the Judiciary*, 108th Cong., 2d Sess., at 65 (2004) (Rep. Meeks) ("some states have alleged that income-based taxes are due from media corporations simply because they broadcast programs into the state"); *id.* at 88-89 (statement of Bo Horne and Kathy Horne, owners of a home-based software development company).

frey's lead and have allowed the imposition of income and franchise taxes even absent a physical presence within the State. *See infra* at 12-15.

There is now a clear and irreconcilable division of authority on this important question. The result is an untenable patchwork of standards, in which some state taxing authorities are permitted to tax out-of-state entities that lack physical presence and others are not, and in which no corporation can predict whether and where its commercial activities will subject it to state taxation. The scope of the States' authority to tax beyond their borders is an issue of fundamental importance to virtually every business involved in interstate or international commerce. It is of particular significance to that critically important sector of the economy that engages in commerce over the internet. These new tax assessments violate settled expectations upon which large segments of the American economy have relied in development and long-term planning, and they directly burden and disrupt the free flow of interstate commerce that the Commerce Clause exists to protect. That disruption will necessarily intensify until this Court clarifies and confirms the application of the longstanding physical presence rule to all state taxes. Certiorari should be granted.

STATEMENT OF THE CASE[3]

1. Petitioner Lanco, Inc. ("Petitioner" or "Lanco"), was at all times relevant to this litigation a Delaware corporation that owned trademarks, tradenames and service marks ("intellectual property") which it licensed to Lane Bryant, Inc. ("Lane Bryant"), a corporation engaged in the retail sale of women's clothing and accessories, for Lane Bryant's use nationwide. Lane Bryant had stores in New Jersey, and used

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[3] All the facts recited in this Petition are taken from the stipulated factual record; no facts in this case were ever in dispute.

Lanco's intellectual property that it had licensed in connection with its operations of those stores. App. 6a, 53a.

Lanco had no New Jersey office and conducted all of its business, including all of its licensing activities, outside the State. *Id.* 53a-54a. Lanco had no employees or agents in the State and maintained no bank or other financial accounts in New Jersey. *Id.* 53a Lanco held no interests in real or personal property located in New Jersey. *Id.* Lanco and Lane Bryant had a common ultimate parent company. As the decisions below specifically found, however, their affiliation was not relevant to the determination by Respondent that tax was owed and was therefore immaterial to the constitutional issue presented by that determination. *See Id.* 6a-7a; *see also infra* at 23 n.9. The parties stipulated that Lanco licensed its property to Lane Bryant at arms-length rates. *Id.* 53a.

Respondent, the Director of the New Jersey Division of Taxation, issued a notice to Lanco that asserted that Lanco was subject to New Jersey's Corporation Business Tax ("CBT"), N. J. Stat. Ann. § 54:10A-1, *et seq.* – which is denominated a "franchise tax" and which imposes a tax upon a portion of a corporation's "entire net income" – because of its receipt of royalties from Lane Bryant. Petitioner filed this action in the New Jersey Tax Court challenging the imposition of this New Jersey tax upon it.

The New Jersey Tax Court concluded that, because Petitioner had "no physical presence" in the State, it did not have a "substantial nexus" to New Jersey, and that imposition of the CBT in this case violated Commerce Clause limitations on the State's taxing authority. App. 21a-42a. The Tax Court rejected Respondent's argument that the Commerce Clause does not require physical presence when a state income tax is at issue, rather than a sales and use tax like the one at issue in *Quill*. The Tax Court explicitly noted the division of authority on this question, App. 32a-33a. Recognizing that "the precedents continue to require physical presence for nexus," the court concluded that if "physical pres-

ence is a constitutional necessity for one, it is illogical that it should not be for both." App. 29a.

2. The Appellate Division of the Superior Court of New Jersey reversed. App. 4a-20a. The sole basis for imposing the tax on Lanco, the court explained, was "that Lanco derived receipts from sources in the State." *Id.* 5a. "Thus," the Appellate Division continued, "the critical issue is whether the taxpayer must have a physical presence in the state in order to constitute the required 'substantial nexus' necessary to satisfy the Commerce Clause under *Quill*." *Id.* 6a.

The Court held that Petitioner need not have a physical presence in the State in order to be subject to the State's income tax: "We agree with the Director that *Quill* does not apply to taxes other than sales and use taxes, and that the Corporation Business Income Tax may be constitutionally applied to impose a tax on plaintiff's income from licensing fees attributable to New Jersey." App. 11a (citation omitted); *see also id.* 20a (restating this holding).

Lanco sought review of the decision in the New Jersey Supreme Court, and the Division of Taxation did not oppose, agreeing that the "Appellate Division decision addresses a substantial question under the United States Constitution on which there is a divergence of precedent and that it is in the [Director's] interest to have the question resolved." *See* Certification of New Jersey Assistant Attorney General Patrick DeAlmeida in No. 58,542, *Lanco, Inc. v. Director, Division of Taxation* at 2, ¶[8 (N.J. Filed Nov. 15, 2005).

3. The New Jersey Supreme Court affirmed "substantially for the reasons expressed in" the opinion of the Appellate Division. App. 2a. It wrote only to add explicitly that

> Since the Court decided *Quill*, a split of authority has developed regarding whether the Supreme Court's holding was limited to sales and use taxes. *See, e.g., A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 193-96 (N.C. Ct. App. 2004)) (holding

> North Carolina can impose corporate franchise and income taxes on companies not physically present in North Carolina), *certif. denied*, 359 N.C. 320, *cert. denied*, 126 S. Ct. 353 (2005); *J.C. Penney Nat'l Bank v. Johnson,* 19 S.W.3d 831, 838-39 (Tenn. Ct. App. 1999) (holding Tennessee cannot impose franchise and excise tax on company not physically present in Tennessee), *cert. denied*, 531 U.S. 927 (2000).
>
> We believe that the better interpretation of *Quill* is the one adopted by those states that limit the Supreme Court's holding to sales and use taxes. . . . . We therefore affirm the Appellate Division's determination that the Director constitutionally may apply the Corporation Business Tax notwithstanding a taxpayer's lack of a physical presence in New Jersey . . . .

App. 2a-3a.[4]

4. Because there is a division of authority about the important constitutional question involved in this case, this Petition followed.

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[4] The New Jersey Supreme Court ordered a remand upon which the New Jersey Tax Court entered judgment for Respondent. *See Lanco v. Tax Division*, No. 005329-1997, Consent Order and Judgment (N.J. Tax Ct. January 8, 2007). This limited remand does not affect the decision's finality for purposes of this Court's jurisdiction under 28 U.S.C. § 1257. *See Pope v. Atlantic Coast Line R.R. Co.*, 345 U.S. 379, 382 (1953).

REASONS FOR GRANTING THE PETITION

I. THE STATES ARE IN CONFLICT OVER THE APPLICABILITY OF THE *BELLAS HESS/QUILL* PHYSICAL PRESENCE REQUIREMENT TO INCOME AND FRANCHISE TAXES.

The States are divided on the question whether the Commerce Clause prohibits the imposition of income and franchise taxes upon out-of-state corporations with no in-state physical presence. With its decision below, the New Jersey Supreme Court has taken one side in this conflict about the meaning of the Constitution. This Court should act to resolve this division of authority.

A. Several State Supreme Court And Appellate Court Decisions Require Physical Presence For Income And Franchise Taxes.

The decision below squarely conflicts with the decision of the highest court of Tennessee and with the unchallenged decisions of appellate courts in other States. In *J.C. Penney National Bank v. Johnson*, the Tennessee Supreme Court upheld on its merits a decision that state taxing authorities could not impose upon out-of-state corporations with no in-state physical presence excise and franchise taxes on corporate earnings or profits. The Tennessee Court of Appeals held that no valid distinction can be drawn for Commerce Clause purposes between excise and franchise taxes and the sales and use taxes at issue in *Bellas Hess* and *Quill*:

> The only real issue is whether there is any reason to distinguish the present case from *Bellas Hess* and *Quill*. The Commissioner argues that those cases are distinguishable because they involved use taxes, whereas the present case involves franchise and excise taxes. We must reject the Commissioner's argument. While it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case. In fact, the Commissioner is

> unable to provide any authority as to why the analysis should be different for franchise and excise taxes.

J.C. Penney, 19 S.W.3d at 839.

The Tennessee Supreme Court then issued an Order denying review and allowing the Court of Appeals decision to be published. *See J.C. Penney Nat'l Bank v. Johnson, Comm'r of Revenue*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000) (per curiam). Denial of review by the Tennessee Supreme Court – unlike denial of certiorari by this Court – establishes agreement with the result below.[5] Further, by allowing the Court of Appeals opinion to be published, the Tennessee Supreme Court gave it statewide precedential effect. As the Tennessee Supreme Court has explained, "the published opinions of the intermediate appellate courts are opinions which have precedential value and may be relied upon by the bench and bar of this state as representing the present state of the law with the same confidence and reliability as the published opinions of this Court, so long as either are not overruled or modified by subsequent decisions." *Meadows v. State*, 849 S.W.2d 748, 752 (Tenn. 1993); see also Tenn. Code Ann. §16-4-113 (2007) (Tennessee Court of Appeals is a court of statewide jurisdiction). It is thus now settled law in Tennessee that taxes upon income are subject to the *Bellas Hess/Quill* physical-presence rule.

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[5] *See, e.g., State v. Cawood*, 134 S.W.3d 159, 164 n.6 (Tenn. 2004) ("when the Supreme Court denies a writ of certiorari, the Court takes jurisdiction and makes a final disposition of the case by approving the final decree of the intermediate court"); *Pairamore v. Pairamore*, 547 S.W.2d 545, 548-549 (Tenn. 1977) ("When we deny the writ, we . . . have made a final disposition of the case by approving the final decree of the Court of Appeals. . . . [D]enial of the writ necessarily puts the stamp of approval on the results reached in the final decree of the intermediate court. . .").

Appellate courts in Michigan and Texas have also rejected attempts by their state revenue departments to impose taxes on the basis of receipts derived from in-state sources, holding that under this Court's decision in *Quill*, the Commerce Clause precludes a State from imposing franchise or income taxes on an entity that does not have a physical presence in the State.

The Michigan Court of Appeals rejected the State's effort to deviate from *Quill* in *Guardian Industries Corp. v. Department of Treasury*, 499 N.W.2d 349, 377 (Mich. Ct. App. 1993), *appeal denied*, 512 N.W.2d 846 (Mich. 1994). Michigan appellate decisions are binding precedent statewide. *See Tebo v. Havlik*, 343 N.W.2d 181, 185 (Mich. 2004); *Straman v. Lewis*, 559 N.W.2d 405, 406 (Mich. App. 1996). And, while the Michigan Supreme Court has not ruled on the issue, following the denial of review of the *Guardian* case by that court, the Michigan Department of Revenue announced that it would adhere to the physical presence standard. *See J.W. Hobbs Corp. v. Dep't of Treasury*, 706 N.W.2d 460, 463 (Mich. App. 2005). Because the State has accepted this decision, it no longer seeks to impose taxes on corporations that are not physically present, and there is no prospect of further state court judicial review of the question. In Michigan, then, the physical presence test is settled law.

In *Rylander v. Bandag Licensing Corp.*, the Texas Court of Appeals held that a franchise tax could not be imposed on a corporation that lacked physical presence in Texas and whose only connection with Texas was by way of interstate commerce. *See Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 298-300 (Tex. App. 2000), *review denied*, No. 00-0646 (Tex. January 11, 2001). In Texas, that appellate decision is binding precedent. *See Messina v. State*, 904 S.W.2d 178, 181 (Tex. 1995). The Texas decision in *Bandag* has been on the books and has governed taxation by the State for the past six years. The Texas Supreme Court de-

nied review in that case, has not taken it up in the years since, and, because of its discretionary docket, cannot be compelled to address the question. Corporations deciding whether to file tax returns in Texas thus rely on *Bandag*'s holding that the state's taxing power remains governed by the *Bellas Hess/Quill* physical presence rule with regard to all types of taxes.

In addition to these judicial rulings, a number of other States appear to have responded administratively to the movement among the States to tax out-of-state corporations that lack a physical presence in-state by making clear that the will not seek to exercise any such taxing authority. *See* 2006 Survey of State Tax Departments, (BNA). Vol. 13, No. 4 at S-20-21 (April 28, 2006), available at http://www.bna.com/states/statesurvey/2006survey.pdf (last visited March 5, 2007) (indicating that the tax authorities of Connecticut, Mississippi, Missouri, New York and Virginia also would not find a sufficient nexus to support imposition of an income-based tax where an out-of state company licensed trademarks for use in-state). These interpretations of the nexus requirement are effectively the settled law in these States, too, for as long as these interpretations remain in place there will be no judicial review of these positions because no taxes subject to challenge are imposed.

B. Other State Supreme Court And Appellate Court Decisions Reject a Physical Presence Requirement For Income And Franchise Taxes.

On the other side of the split, in addition to the Supreme Court of New Jersey below, the highest courts of South Carolina, West Virginia and Ohio have held that, despite *Quill* and *Bellas Hess*, States may impose income and franchise taxes upon out-of-state entities with no physical presence in the State. *See Tax Comm'r v. MBNA Am. Bank*, 640 S.E. 2d 226, 234 (W. Va. 2006); *Geoffrey*, 437 S.E.2d at 18; *Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225, 1230 (Ohio 1996), *cert. denied*, 519 U.S. 810 (1996); *see also*

Buehner Block Co. v. Wyo. Dep't of Revenue, 139 P.3d 1150, 1158 n.6 (Wyo. 2006) (stating that "*Bellas Hess* and *Quill* . . . created [a] specialized jurisprudence" applicable to "sales or use tax case[s]").

The West Virginia Supreme Court's recent decision in *MBNA* squarely addresses the issue presented here and – like the decision below – acknowledges the direct conflict in authority:

> [T]he United States Supreme Court's determination in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), that an entity's physical presence in a state is required to meet the "substantial nexus" prong of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), applies only to state sales and use taxes and not to state business franchise and corporation net income taxes. . . . Rather than a physical presence standard, this Court believes that a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes. . . . We reject the reasoning in *J.C. Penney*, and decline to apply it to the instant case.

MBNA, 640 S.E.2d at 234. In a microcosm of the broader conflict, the *MBNA* decision divided the West Virginia Supreme Court. A spirited dissent explained why the majority's refusal to apply the physical-presence test to income and franchise taxes contradicts this Court's Commerce Clause taxing power jurisprudence:

> The reality is that the United States Supreme Court has not generally treated the question of state authority to tax interstate commerce as turning on the specific type of tax involved. Rather, the . . . Court has focused instead on the effect of the tax which the taxing state seeks to levy on interstate commerce . . . . Indeed, there is no immediately clear doctrinal foundation which can be observed for distinguishing sales and use tax collection on sales between states from

> income taxes sought to be collected from out-of-state companies for income realized from out-of-state intangible accounts simply because the out-of-state corporation availed itself of the United States mails and other forms of interstate communication.

640 S.E. 2d at 239 (Benjamin, J., dissenting).

Like the West Virginia Supreme Court, the Ohio Supreme Court has held that "the physical-presence requirement of *Quill* is not applicable" to state income taxation. *See Couchot*, 659 N.E.2d at 1230; *see also id.* at 1230-31 (physical presence test would "in any event have been satisfied" had it been applicable).

State appellate court decisions rendered in several other States have also held that the physical presence requirement for "substantial nexus" under the Commerce Clause applies only in cases involving sales and use taxes. *See Kmart Props., Inc. v. Taxation & Revenue Dep't of N.M.*, 131 P.3d 27, 35 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22 (N.M. 2005); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194-195 (N.C. 2004), *certif. denied*, 611 S.E.2d 168 (N.C.), *cert. denied*, 126 S. Ct. 353 (2005); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632, 638 (Okla. Civ. App. 2005); *Gen. Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1029 (Wash. App.), *pet. rev. denied en banc*, 84 P.3d 1230 (Wash. 2001), *cert. denied*, 535 U.S. 1056 (2002).

Finally, some other States have amended their statutes, promulgated regulations, or issued other directives that assert authority to tax corporations that lack a physical presence in the State, thereby restricting *Quill's* physical presence requirement to sales and use taxes. *See, e.g.*, Ark. Reg. 1996-3 (licensing of intangibles in an intragroup intangible licensing transaction creates nexus); Fla. Admin. Code Ann. r. 12C-1.011 (p)1 (2007) (selling or licensing the use of intangibles creates nexus); Iowa Admin. Code r. 701.52.1(422), 52.1(1)d (2007) (citing *Geoffrey* and providing that licensing intangibles to corporations doing business in Iowa creates nexus);

Directive 96-2 (Mass. Dep't of Revenue July 3, 1996) (licensing of intangibles for use in Massachusetts creates nexus); Minn. Stat. § 290.015(1)(c)(3) (2005) (providing that business within Minnesota includes transactions with customers in the State that involve intangible property and results in receipts attributable to Minnesota); Okla. Admin. Code § 710:50-17-3(a)(9) (2005) (licensing of intangible rights for use in Oklahoma creates nexus); Wis. Admin. Code Tax § 2.82(4)9 (2007) (licensing of intangible rights for use in Wisconsin creates nexus).

C. Certiorari Should Be Granted Now To Resolve This Important Conflict.

The States are thus conclusively divided on the question presented; there is no prospect that the conflict will resolve itself absent this Court's intervention. Nor is there any reason to await further development of the conflict, for the split in authority concerning the Commerce Clause has already had serious adverse consequences for taxpayers and taxing authorities alike. Taxing officials in the various States have been held to have different scopes of taxing authority and out-of-state businesses with no physical presence within taxing States are subject to different taxing regimes.

Uncertainty inhibits business planning and investment and is extraordinarily costly from a fiscal and societal vantage point. Federal courts, of course, are generally barred by the Tax Injunction Act from adjudicating the constitutionality of state taxes. *See* 28 U. S. C. § 1341. Thus, absent this Court's review, this patchwork of state court decisions and state regulations construing the federal Constitution will continue – without any federal judicial guidance. If businesses – both domestic and foreign – that lack physical presence in a State need not pay state income and franchise taxes, those businesses should know that. And if state taxing authorities have the power to impose taxes in the absence of physical presence – particularly those who are not exercising that

power in the belief that *Quill* forbids it – those authorities should know that, too.

The need for clarity on this topic is especially pressing in light of new requirements of corporate transparency in accounting. The new Financial Accounting Standards Board Interpretation No. 48 (FIN 48), entitled Accounting for Uncertainty in Income Taxes, prescribes how a company must measure, and disclose in its financial statements, the tax positions that the company has taken, including decisions whether or not to file a return in particular jurisdictions.[6] FIN 48 requires a company to measure and disclose whether it is "more likely than not" that each taxing authority will conclude (based on the position's technical merits) whether the company is required to pay taxes in that State, without consideration of the likelihood that the taxing authority will examine the company's position. Unless a company can show that the taxing authority would, more likely than not, sustain the company's position that it need not file a return, "the company would be required to recognize a FIN 48 liability, interest, and, potentially, penalties" in its financial statements. Charles E. Berg, Practising Law Institute, Preparation of Annual Disclosure Documents 2007: PricewaterhouseCoopers Datalines Regarding Hot Button Accounting Issues, No. 2006-18 (Jan. 2007). If there is uncertainty about whether the State is correct or the taxpayer is correct, the taxpayer's decision not to file a tax return "would prevent the statute of limitations from kicking in, and thus the FIN 48 liabilities [on its financial statement] would possibly never reverse, and interest would accrue [on the financial

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[6] This interpretation became effective for fiscal years beginning after Dec. 15, 2006, and public companies must abide by that interpretation in preparation of their financial statements filed with the Securities and Exchange Commission. *See* SEC, Codification of Financial Reporting Policies § 101, reprinted at 7 Fed. Sec. L. Rptr. (CCH) ¶72,921.

statement] in perpetuity." *Id.* Uncertainty about the requirements of the law in this area thus could have profound consequences for the publicly reported financial health of a corporation, and for shareholder value, the ability to raise capital, and so on.

This issue also has implications even beyond our national borders. Under most of the more than fifty bilateral tax treaties to which the United States is a party, the United States has agreed to tax foreign corporations only if they have a "permanent establishment" in the United States, which is normally defined as a "fixed place of business through which the business of an enterprise is wholly or partly carried on." The federal government's support of the "permanent establishment" concept is most recently reflected in Article V of the Model Income Tax Convention of November 15, 2006, issued by the U.S. Department of Treasury, available at www.ustreas.gov/press/releases/reports/hp16801.pdf (last visited March 5, 2007), which the government uses as a basis for all tax treaty negotiations. These treaties are of particular concern here because they generally do not constrain the power of States and localities to impose taxes on foreign corporations. *See Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 196-197 (1983); Jerome B. Libin & Timothy H. Gillis, *It's a Small World After All: The Intersection of Tax Jurisdiction at International, National, and Subnational Levels*, 38 Ga. L. Rev. 197, 254-255 (2003). Consequently, if the decision below is permitted to stand, a foreign corporation without a "fixed place of business" in the United States may find itself subject to tax by States that reject a physical presence requirement, even though the foreign corporation would not be subject to federal income tax based on a bilateral treaty. New Jersey, in fact, has already begun circulating nexus surveys to foreign affiliates of domestic corporations. *See, e.g.*, State of New Jersey Nexus Survey (July 17, 2006), available at http://www.ofii.org/njltr.pdf (last visited March 5, 2007). This substantial risk of divergent treatment by federal and state tax authorities is contrary

to the important federal interest underlying U.S. tax treaties, which is to protect U.S. businesses from overly burdensome foreign taxation by ensuring that both the United States and its trading partners assert taxing authority on generally the same terms.

II. THE DECISION BELOW IS WRONG AND CONFLICTS BOTH WITH THIS COURT'S COMMERCE CLAUSE DECISIONS AND WITH THE PRINCIPLES OF FEDERALISM THEY REFLECT.

A. This Court's Commerce Clause Precedents Do Not Distinguish Among Types Of State Taxes.

The courts that have limited the *Bellas Hess/Quill* physical-presence requirement to sales and use taxes – including the court below, *see* App. 3a – have relied heavily on the observation in *Quill* that "we have not, in our review of other types of taxes, articulated the same physical-presence requirement." 504 U.S. at 314. That phrase, as Respondent's argument here will likely reflect, has played a critical role in the widespread controversy discussed in this Petition – which is all the more reason this Court should revisit the issue to clarify the implications of its own dictum. In fact the dictum has been fundamentally misread by the lower courts that have relied on it. Those courts have used it as license to hold what there is no principle to support, i.e., that sales and use taxes differ materially from income and franchise taxes for purposes of the Commerce Clause. There is simply no basis in precedent or logic for such a distinction.

The basic Commerce Clause rule has always been a general one: "[T]he interstate business must have a substantial nexus with the State before *any tax* may be levied on it." *Commonwealth Edison Co. v. Montana,* 453 U.S. 609, 626 (1981) (emphasis added). This Court set forth the analysis that includes the "substantial nexus" requirement in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), a case involving sales tax. But *Complete Auto* itself relied on franchise tax precedent. *See id.* at 285-287 (citing *Colonial*

Pipeline Co. v. Traigle, 421 U.S. 100, 101 (1975)). And the Court noted in *Complete Auto* that its analysis had been applied by the Court to "many types of tax." 430 U.S. at 279. This Court has subsequently used the same analysis to assess the constitutionality of state income taxes under the Commerce Clause. *See, e.g., Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 311 & n.10 (1994); *Amerada Hess Corp. v. Dir., Div. of Taxation*, 490 U.S. 66, 73 (1989).[7]

More generally, the Court in *Complete Auto* emphasized that the label given to a tax will not result in different analyses or results under the Constitution. "A tailored tax, *however accomplished*, must receive the careful scrutiny of the courts to determine whether it produces a forbidden effect on interstate commerce." 430 U.S. at 289 n.15 (emphasis added). Accordingly, in discussing the Commerce Clause nexus requirement, this Court has routinely referred to cases involving sales and use taxes interchangeably with cases involving direct taxes such as income and franchise taxes, undermining the idea that there are different nexus requirements for different kinds of taxes. *See, e.g., National Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551, 555-59 (1977).

Whether a State imposes an obligation to collect sales and use taxes on gross receipts from in-state customers, or a direct tax on the profits or earnings realized from those gross receipts, the taxes are essentially indistinguishable in their economic effects. There certainly is no logical reason a State that cannot under the Commerce Clause impose sales and use taxes upon out-of-state companies with no physical presence in the State should be able to impose income and fran-

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[7] Indeed in the *Barclays Bank* case the Court specifically noted in the course of finding that a State's imposition of an income tax met the substantial nexus standard that *Quill*'s physical presence requirement was satisfied. See *Barclays Bank*, 512 U.S. at 311 n.10.

chise taxes upon them. No court has been able to demonstrate otherwise.

Indeed, as this Court has explained, if anything, the economic burdens upon interstate commerce of income taxes on interstate businesses are actually *greater* than the consequences of sales and use tax collection obligations. *See National Geographic*, 430 U.S. at 558. The laws invalidated in *Bellas Hess* and *Quill* were not direct taxes on out-of-state entities, but were obligations to collect sales and use taxes from in-state customers. By contrast, income and franchise taxes are *direct* taxes imposed upon the out-of-state entity. Whereas a collection obligation generally imposes only the administrative burden of collecting the tax at the point of sale, a direct tax imposes both administrative burdens *and* immediate financial obligations. *Id.* It also exacerbates the risk of double taxation, a serious and unfair financial burden. *Id.*[8]

Moreover, the complexity and burden of complying with corporate income and franchise taxes are greater than the

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[8] Nor of course is there any bright line between what might be denominated "sales and use" taxes on the one hand, and what might be denominated "franchise and income" taxes on the other. Taxes on "gross receipts," for example, could be described as taxes on sales within the State, or as taxes on income received outside the State. States have sometimes been quite skillful at using labels to attempt to avoid restrictions on their taxing power. In situations where States have determined that it was advantageous to have a tax not be considered a "net income tax" in order to avoid restrictions imposed by Congress in Pub. L. 86-272, which prohibits imposition of state "net income taxes" based solely upon solicitation of orders in-state for sales of tangible personal property, the States have deftly avoided the congressional limitation. *See* Pub. L. 86-272, 73 Stat. 555, codified at 15 U.S.C. §381. For example, New Jersey has enacted an "alternative minimum assessment," a component of its corporation business tax, which is computed on gross receipts or gross profits, and it now is applied only to entities that claim protection against state income taxes under Pub. L. 86-272. *See* N.J. Stat. Ann. § 54:10A-5a.e (2007).

complexity and burden of sales and use tax compliance. Income tax compliance involves apportionment formulae, sourcing and inclusion definitions, legal entity classification, classification of income, depreciation, disclosure requirements, and other elements. And each of these elements could and likely would vary among the thousands of potential direct taxing jurisdictions. As a result, abandoning the physical presence test and permitting States and localities to impose broad income and franchise tax liability will force businesses to confront and comply with a bewildering array of differing rules that would generate enormous compliance costs. The costs are at least as burdensome as those that would be involved if the States were allowed to impose sales and use tax collection and remittance obligations.

And, as the Court in *Quill* recognized, the increased compliance obligations created by relaxed nexus requirements for any tax necessarily increase the burden on interstate commerce. This Court noted the broad burden that would have been imposed by the North Dakota law struck down in *Quill* which would have imposed a tax collection duty on every vendor who advertised in the State three times in a single year. 504 U.S. at 313 n.6. New Jersey would impose its tax obligation at least as broadly: a New Jersey statute purports to impose its CBT as broadly as is permitted by the federal Constitution. N.J. Stat. Ann. § 54:10A-2 (2007) ("A taxpayer's exercise of its franchise in this State is subject to taxation in this State if the taxpayer's business activity in this State is sufficient to give this State jurisdiction to impose the tax under the Constitution and statutes of the United States."). Even "more significant" to the *Quill* Court than the breadth of the taxing obligation imposed by the State before it was the fact that "similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions." 504 U.S. at 313 n.6. The same is true here: absent a physical presence rule, businesses may be subject to income, franchise or gross-receipts taxes wherever they have customers in any of the over 8,000 jurisdictions in the United States

that are authorized to impose such taxes. *See* Ernst & Young, E Tax Alert, Quantitative Economics and Statistics; State and Local Taxation (March 7, 2007) available through http://www.ey.com/global/content.nsf/US/Tax_-_Quantitative_Economics_and_Statistics_-_Overview (indicating number of jurisdictions authorized to impose such taxes).

B. The Bright-Line, Physical-Presence Requirement Provides A Judicially Manageable Default Rule.

The physical presence test provides what this Court has described as a "bright-line" rule, which "encourages settled expectations and, in doing so, fosters investment by businesses and individuals." *Quill*, 504 U.S. at 316. Equally important, the bright-line, physical-presence requirement is both principled and judicially manageable.

The courts rejecting a physical presence requirement for income and franchise taxes have used varying formulations for the tests that replace it, but none provides any principled, judicially manageable limitation on state authority to tax. The West Virginia Supreme Court's decision in *MBNA* adopts a general "significant economic presence" test, i.e., the State may tax any business with a significant economic presence in the State. Other state appellate court decisions have applied similarly vague tests based on economic presence or commercial activity within the State. *See*, *e.g.*, *Gen. Motors*, 25 P.3d at 1028-29. By contrast, other state-court decisions – including the New Jersey decision below – have adopted what may at first blush appear to be a more limited exception to the physical presence rule, holding at least that that the licensing of "intangible property" for use within a State creates a "presence" that is a sufficient nexus for taxing power under the Commerce Clause. *See* App. 13a-20a;

Geoffrey, 437 S.E.2d at 18; *A&F Trademark*, 605 S.E.2d at 195.[9]

These lines are unprincipled and provide no guidance to the judges who would have to apply them. None is rooted in constitutional principle – no one believes the Commerce Clause is peculiarly concerned with sales and use taxes – and each would permit a State to regulate all interstate commerce involving a customer who lives within the State. Just as the reading of the Commerce Clause proposed in *United States v. Lopez*, 514 U.S. 549 (1995), had no clear stopping point with respect to federal power, *see also infra* at 25-26, elimination of the requirement of physical presence within those borders would effectively eliminate all judicially manageable restrictions upon a State's power to reach beyond its borders to tax interstate commerce.

The "intangible presence" test suggested by the South Carolina Supreme Court in *Geoffrey* and to which the New Jersey Supreme Court below referred provides no limit to state authority because a license for use of intangible property ultimately is indistinguishable from any other commercial sale, license, contract, or other transaction with an in-state resident. *See infra* at 26-28. The contractual right to

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[9] Several decisions rejecting the physical presence requirement involved out-of-state entities in commercial relationships with affiliated in-state entities that paid licensing or other fees to the out-of-state entities, and at least one decision specifically relied on the affiliations as establishing a substantial nexus between the State and the out-of-state entity. *See A&F Trademark*, 605 S.E.2d at 195. Properly understood, this is irrelevant to the constitutional calculus. If a State is concerned about payments by an in-state entity to an out-of-state affiliate based on a belief that the affiliate is some type of sham or there is not, in fact, an arms-length relationship, that concern is properly addressed by the State through examination of the tax liability and returns of the in-state entity. Such a concern does not warrant elimination of the constitutional boundary between what a State may regulate beyond its borders and what it may not.

use intellectual property is no different from the contractual right to receive a product purchased by mail order or online transaction, *see Quill*. The universe of potential taxpayers is therefore the universe of companies that have customers in the taxing State. Likewise, the "economic presence" test articulated by the West Virginia Supreme Court of Appeals in *MBNA* imposes no restraint on state power to tax interstate commerce. All out-of-state companies that sell goods and services to customers in-state have an "economic presence."

A court could in theory impose some limit on the taxing power under these standards, but only by making an artificial determination of what kind and what degree of economic contact with a State, or of what intangible property present in the State, is sufficient to create a "substantial nexus." The articulation of those unprincipled lines, however, would involve an inherently legislative judgment.

It is precisely the genius of this Court's Commerce Clause holdings in *Bellas Hess* and *Quill* that they do not attempt to make this inherently legislative determination themselves, but rather leave Congress with the power to craft a different rule if one is desirable. *Cf. Quill*, 504 U.S. at 320 (Scalia, J. concurring in part and concurring in judgment) (noting that these decisions' claim to *stare decisis* effect has "special force" because of Congress's power to alter them). Unlike the Court, if the Congress rejects physical presence as a requirement for state taxation of out-of state companies, it need not replace it with an unmanageable alternative nor need it be concerned with whether its actions are properly animated by consistent constitutional principle. Congress may craft a nuanced approach that it believes meets the nation's needs and addresses whatever concerns exist about requiring physical presence for taxation. Congress even could carve out *ad hoc* exceptions from the physical presence rule if it were to find the need. This is a task to which the courts are by definition not suited.

C. The Physical-Presence Test Reflects And Reinforces The Structure Of Our Federal System.

Finally, the physical-presence rule is animated by principles of federalism, which divides authority both between the States and the federal government, and among the individual States.

The modern economy may lack borders, but States do not. Indeed, if state boundaries mean nothing, then States mean nothing: the only thing that distinguishes one political entity called a "State" from another in our federal system is the geographic boundaries that define them. Since *Quill*, this Court has emphatically reaffirmed the constitutional significance of the States' geographical boundaries. It has reiterated the Constitution's structural limitations on the States' power to regulate beyond their borders, *see State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 421 (2003); *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 569-71 (1996), as well as the Commerce Clause's limitations on Congress's power to regulate certain activities having impacts only within those state boundaries, *see United States v. Lopez*, 514 U.S. 549, 567 (1995).

The Commerce Clause requirement of physical-presence is a reflection of the same geographical principle underlying these precedents. Physical borders are the necessary limit of a State's authority to tax. As Justice Kennedy wrote for the Court in 1992: "In a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation." *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 777-778 (1992). By the same token, "[T]he theory that two governments accord more liberty than one requires for its realization two distinct and discernable lines of political accountability: one between the citizens and the Federal Government; the second between the citizens and the States. . . . Our position in enforcing the dormant Commerce Clause is instructive. . . . One element

of our dormant Commerce Clause jurisprudence has been the principle that the States may not impose regulations that place an undue burden on interstate commerce, even where those regulations do not discriminate between in-state and out-of-state businesses." *Lopez,* 514 U.S. at 576-580 (Kennedy, J., concurring).

By giving decisive weight to the taxpayer's physical presence within state borders, the rule of *Bellas Hess* and *Quill* respects and reinforces the very concept of the State itself. By contrast, if the physical presence of taxpayers becomes irrelevant to a State's power over them, and a State is allowed to exert broad taxing authority solely on the basis of activity in commercial markets that are by now essentially borderless and worldwide, then state power becomes effectively unmoored from the very feature of the State that gives it constitutional status, i.e., its sovereignty over a specified geographical area and those who come within it.

D. The Idea That the Use in a Particular State by a Licensee of a Business's Intangible Property Alone Constitutes a "Presence" of that Business in that State Does Not Provide a Principled Distinction from Instances Where Physical Goods Alone are Shipped into a State.

The decision below permits taxation of income of a company with no in-state physical presence where that company's intangible property is being used by someone else within the State who has licensed it. As described above, decisions on which the courts below relied asserted that because companies like Petitioner license intellectual property, their "intangible property" is "present" in the State in which the licensee uses it in a way that differentiates them from sellers like those in *Quill* whose physical goods are shipped into the State. App.19a. In fact, the transactions at issue here are indistinguishable in principle from the transactions at issue in *Quill* which the Court found insufficient to establish a "substantial nexus" with the taxing State. The fact that

they involve intangible intellectual property is immaterial to the Commerce Clause question.

To begin with, by its nature intangible property "ha[s] no actual territorial situs." *Farmers Loan & Trust Co. v. Minnesota*, 280 U.S. 204, 211 (1930). It is true that it is sometimes said to have a situs for tax purposes, but the situs generally follows the person who owns it or, in some cases, the activities in which he or she is engaged. *Curry v. McCanless*, 307 U.S. 357, 368 (1939). In this case, of course, Petitioner has no presence in and has conducted no activities in the taxing State.

More fundamentally, the transactions at issue in a case like this – the sale by an out-of-state company of a license to intellectual property for its use by an in-state customer – are economically identical to the transactions at issue in *Bellas Hess* and *Quill*: the sale by an out-of-state company of goods for use by an in-state customer. The use of Petitioner's trademark inside the taxing State by the customers who licensed it is indistinguishable from the use in *Bellas Hess* and *Quill* of the mail order house's goods inside the taxing State by the customers who purchased them. And those cases make clear that the sale of goods and services within a State is not an adequate basis for imposing tax on an out-of-state entity with no in-state physical presence.

Unsurprisingly, the idea that a licensee's use of a corporation's intangible property in a taxing State could be equated for Commerce Clause purposes with physical presence of that corporation sufficient to permit state taxation was woven from whole cloth. The idea was conceived by the *Geoffrey* court, which asserted incorrectly that "[i]t is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property alone is sufficient to establish nexus." *Geoffrey*, 437 S.E.2d at 18. That is simply false: In support of the proposition *Geoffrey* cited a single New Mexico state case that did not even discuss intangible property in the con-

text of the nexus requirement under the Commerce Clause, *Am. Dairy Queen Corp. v. Taxation & Revenue Dep't*, 605 P. 2d 251, 255 (N.M. Ct. App. 1979).[10]

Nor has this Court in its modern Commerce Clause jurisprudence ever allowed intangible property alone to form a basis for state taxation. The Petitioner in *Quill* could be said to have had "intangible property" with a "legal situs" in the taxing State: its "going concern value" calculated based on its gross receipts from sales in that State. *See Complete Auto*, 430 U.S. at 284 (describing a tax on such intangible property). Yet in *Complete Auto*, this Court rejected precisely the approach that permitted taxation on the basis of the presence of such property where it was otherwise forbidden by the Commerce Clause. The fact that this case involves intangible intellectual property thus can do nothing to eliminate the conflict with the decisions of this Court.

III. THIS COURT SHOULD AGAIN INTERVENE TO PROTECT THE FREE FLOW OF INTERSTATE COMMERCE.

This is not the first time this Court's intervention in this context has been necessary. The law challenged in this case is part of a third wave of state tax laws that have targeted

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[10] *Geoffrey* also said that a "taxpayer who is domiciled in one state but carries on business in another is subject to taxation measured by the value of the intangibles used in his business." *Geoffrey*, 437 S.E.2d at 18 (citing *Curry v. McCanless*, 307 U.S. 357, 368 (1939)). This confuses the question of "the guidelines necessary to circumscribe the reach of the State's legitimate power to tax," with "[t]he constitutional question . . . whether the State has the authority to tax the corporation at all." *Allied-Signal*, 504 U.S. at 778. But in any event, *Curry*, a Fourteenth Amendment case, actually holds that intangibles may be taxed in the State where their owner conducts "his activities." 307 U.S. at 367. This is essentially a restatement of the physical presence test, *see supra* at 2 n.1. Only the in-state conduct or presence of the *owner* of the intangibles – here, Petitioner – can provide the constitutionally required nexus for state taxation.

nonresidents in order to enrich state fiscs. The constitutionality of the first wave of laws was resolved by this Court in *Bellas Hess*, when the Court held that the physical presence of a company in a State is required before that State can require a company to collect and remit use taxes to the State.

By 1992, however, 34 States had amended their tax statutes to impose tax collection obligations upon out-of-state direct marketers and, despite the clear prohibition on such taxation set out in *Bellas Hess*, state courts were sustaining the constitutionality of those state laws. That second wave of laws resulted in this Court's invalidation of such laws and affirmation of the *Bellas Hess* physical presence nexus standard under the Commerce Clause in *Quill*.

Now, the constitutionality of a third wave of laws is being litigated throughout the country. And while the Court in *Quill* was concerned with the effect of state taxes on the reliance interests of the mail-order industry, today's economy includes a much broader and even more vital sector of e-commerce businesses that has developed in reliance on the physical presence rule.

Yet the States' arguments today are the same as those made and rejected in *Quill*.[11] The state courts have issued irreconcilable decisions. The disputes have been costly, time-consuming and, because of the high financial stakes, will continue unabated until this Court grants review. Al-

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[11] North Dakota's arguments in *Quill* included assertions that the business had made a lot of money from in-state customers and should have paid tax to that State on that income; that the business had been provided benefits by the State; that the business would be at a competitive advantage to in-State merchants who necessarily must collect the tax; that *Bellas Hess* was repudiated by this Court's decision in *Complete Auto*, and that *Bellas Hess* was rendered obsolete by the technological and economic changes of the late twentieth century. *See also MBNA*, 640 S.E. 2d at 241 (Benjamin, J., dissenting) (this Court squarely rejected "economic exploitation nexus" arguments in *Bellas Hess* and *Quill*).

though many problems of such magnitude are not easily resolved, this Court has the power and ability to address this one and to ensure that the integrity of the judicial process is not eroded, reliance interests are respected, and the clarity provided by the *Bellas Hess/Quill* rule is restored for this country's business community and tax agencies.

In addition to this Petition, the Court currently has before it a Petition for Certiorari in the *MBNA* case. That decision is a concrete demonstration that the States' abandonment of the physical presence rule has expanded well beyond cases involving intangible property licensees, and now includes virtually every type of business. If the court were inclined to review only one of the two cases, and chose to grant certiorari in *MBNA* because it is arguably more broadly applicable, it should hold this case pending disposition of *MBNA*. In our view, however, the Court, the States, and the substantial interests of businesses operating in interstate commerce throughout the country would be best served by granting both Petitions, hearing the cases in tandem, and affirming the continuing vitality of the physical presence rule.

CONCLUSION

The Petition for a writ of Certiorari should be granted.

Respectfully submitted,

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March 9, 2007

APPENDIX

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APPENDIX A

SUPREME COURT OF NEW JERSEY
A-89 September Term 2005

LANCO, INC.,
a Delaware corporation,

Plaintiff-Appellant,

v.

DIRECTOR, DIVISION OF
TAXATION,

Defendant-Respondent.

Argued September 12, 2006 – Decided October 12, 2006

On appeal from and certification to the Superior Court, Appellate Division, whose opinion is reported at 379 *N.J. Super.* 562 (2005).

Paul H. Frankel, New York City, argued the cause for appellant (McCarter & English, attorneys; *Mr. Frankel*, and *Michael A. Guariglia*, of counsel and on the brief).

Patrick DeAlmeida, Assistant Attorney General, argued the cause for respondent (*Anne Milgram*, Acting Attorney General).

Francis X. Manning, submitted a brief on behalf of *amicus curiae* The Investment Company Institute (Stradley Ronon Stevens & Young, attorneys).

Sheldon H. Laskin, submitted a letter in lieu of brief on behalf of *amicus curiae* Multistate Tax Commission.

PER CURIAM

This appeal involves the issue of whether New Jersey may constitutionally subject a foreign corporation to the Corporation Business Tax, *N.J.S.A.* 54:10A-1 to -41, when the corporation lacks physical presence in New Jersey but derives income through a licensing agreement with a company conducting retail operations in New Jersey. The Appellate Division answered that question affirmatively. *Lanco, Inc. v. Director, Div. of Taxation*, 379 *N.J. Super.* 562, 573 (2005). We agree and affirm substantially for the reasons expressed in Judge Stern's thorough and thoughtful opinion. We write only to add the following brief comments.

In *Quill Corp. v. North Dakota*, 504 *U.S.* 298, 112 *S. Ct.* 1904, 119 *L. Ed.* 2d 91 (1992), the United States Supreme Court affirmed the four-part standard it created in *Complete Auto Transit, Inc. v. Brady*, 430 *U.S.* 274, 97 *S. Ct.* 1076, 51 *L. Ed.* 2d 326 (1977), for cases involving Commerce Clause challenges to state taxation. In that case, the Court determined that, in the context of sales and use taxes, an entity must be physically present in the taxing jurisdiction to establish the constitutionally required "substantial nexus." *Quill, supra*, 504 *U.S.* at 311- 17, 112 *S. Ct.* at 1914-16, 119 *L. Ed.* 2d at 105-10. Since the Court decided *Quill*, a split of authority has developed regarding whether the Supreme Court's holding was limited to sales and use taxes. *See, e.g., A & F Trademark, Inc. v. Tolson*, 605 *S.E.*2d 187, 193-96 (N.C. Ct. App. 2004) (holding North Carolina can impose corporate franchise and income taxes on companies not physically present in North Carolina), *certif. denied*, 359 *N.C.* 320, *cert. denied*, ___ *U.S.* ___, 126 *S. Ct.* 353, 163 *L. Ed.* 2d 62 (2005); *J.C. Penney Nat'l Bank v. Johnson*, 19

*S.W.*3d 831, 838-39 (Tenn. Ct. App. 1999) (holding Tennessee cannot impose franchise and excise tax on company not physically present in Tennessee), *cert. denied*, 531 *U.S.* 927, 121 *S. Ct.* 305, 148 *L. Ed.* 2d 245 (2000).

We believe that the better interpretation of *Quill* is the one adopted by those states that limit the Supreme Court's holding to sales and use taxes. That interpretation reflects the language of *Quill*. In *Quill*, the Court did not attempt to equate the substantial-nexus requirement with a universal physical-presence requirement. *See id.* at 314, 112 *S. Ct.* at 1914, 119 *L. Ed.* 2d at 108 ("[W]e have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes. . . ."). Rather, the Court carefully limited its language to a discussion of sales and use taxes. *See, e.g., id.* at 316, 112 *S. Ct.* at 1915, 119 *L. Ed.* 2d at 109 (acknowledging benefits of imposing bright-line rule "in the area of sales and use taxes"). Simply put, we do not believe that the Supreme Court intended to create a universal physical-presence requirement for state taxation under the Commerce Clause. We therefore affirm the Appellate Division's determination that the Director constitutionally may apply the Corporation Business Tax notwithstanding a taxpayer's lack of a physical presence in New Jersey, and we further affirm the Appellate Division's remand of this matter to the Tax Court for additional proceedings.

JUSTICES LONG, ZAZZALI, LaVECCHIA, ALBIN, WALLACE, and RIVERA-SOTO join in this per curiam opinion. CHIEF JUSTICE PORTIZ did not participate.

APPENDIX B

SUPERIOR COURT OF NEW JERSEY
APPELLATE DIVISION
DOCKET NO. A-3285-03T1

LANCO, INC.
a Delaware corporation,

Plaintiff-Respondent,

v.

DIRECTOR, DIVISION OF
TAXATION,

Defendant-Appellant.

Argued March 3, 2005 – Decided August 24, 2005

Before Judges Stern, Wecker and Graves.

On appeal from a final judgment of the Tax Court of New Jersey, Docket No. 5329-1997,whose opinion is reported at 21 *N.J. Tax* 200.

Patrick DeAlmeida, Deputy Attorney General, argued the cause for appellant (Peter C. Harvey, Attorney General, attorney; Michael J. Haas, Assistant Attorney General, of counsel; Mr. DeAlmeida, on the brief).

Paul H. Frankel, argued the cause for respondent (McCarter & English and Morrison & Foerster of the New York bar, attorneys; Hollis L. Hyans, Craig B. Fields, Amy F. Nogid, Charles M. Costenbader and Mr. Frankel, on the brief).

Stradley Ronon Stevens & Young, attorneys for amicus curiae The Investment Company Institute (Stephen B. Nolan, on the brief).

Rene Y. Blocker, Deputy Director, attorney for amicus curiae Multistate Tax Commission (Mr. Blocker and Sheldon H. Laskin, Director Nexus Program, on the brief).

The opinion of the court was delivered by

STERN, P.J.A.D.

This case presents the important question, as the Tax Court stated it, of "whether New Jersey may constitutionally subject a foreign corporation to the Corporation Business Tax (*N.J.S.A.* 54:10A-1 *et seq.*, 'the CBT'), where the corporation has no physical presence in the state and derives income from a New Jersey source only pursuant to a license agreement with another corporation that conducts a retail business here." *Lanco, Inc. v. Director, Div. of Taxation*, 21 *N.J. Tax* 200, 203 (Tax 2003).

Defendant, Director of the Division of Taxation, appeals from an order of January 9, 2004, entering judgment for plaintiff taxpayer "since it does not have a taxable nexus in the State which would subject it to New Jersey's Corporate Business Tax." Plaintiff, which licenses intellectual property (trademarks, trade names and service marks) to Lane Bryant, a clothing retailer, has no real or personal property or personnel in the State, and the Tax Court, in a published opinion, held that because plaintiff was not physically present in New Jersey, subjecting it to the tax would violate the Commerce Clause of the federal constitution. *Lanco*, *supra*, 21 *N.J.* [*Tax*] at 214. On this appeal the Director argues that Lanco derived receipts from sources in the State, thereby making it subject to the tax, and that "there are no

constitutional impediments to application of the corporation business tax to plaintiff given its substantial nexus to New Jersey" because there was no violation of the due process clause (which is not contested before us)[1] or the Commerce Clause (which is the critical issue contested on the appeal). Thus, the critical issue is whether the taxpayer must have a physical presence in the state in order to constitute the required "substantial nexus" necessary to satisfy the Commerce Clause under *Quill Corp. v. North Dakota*, 504 *U.S.* 298, 112 *S. Ct.* 1904, 119 *L. Ed.* 2d 91 (1992), which applied that test and held physical presence was necessary in the context of a sales and use tax.

The Tax Court succinctly stated the relevant facts as follows:

> Plaintiff Lanco, Inc., ("Lanco") is a Delaware corporation that owns certain intangible property (trademarks, trade names and service marks). The parties have stipulated that Lanco has no offices, employees, or real or tangible property in New Jersey. Lanco licenses Lane Bryant, Inc., ("Lane Bryant") to utilize the intangible property in the conduct of Lane Bryant's retail operations, including those in New Jersey, and in return receives royalty payments from Lane Bryant. Lanco and Lane Bryant are affiliated corporations, but the common ownership is not material to the constitutional issue concerning the determination by the defendant, Director of the Division of Taxation

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[1] We need not comment on the Tax Court's thorough and well reasoned analysis of the Due Process issue, *see Lanco, supra,* 21 *N.J. Tax* at 214-17, as plaintiff does not endeavor to defend the judgment on due process grounds.

> ("Director"), that activity under the license agreement makes Lanco subject to taxation in New Jersey. It is the determination that Lanco is obliged to file under the CBT, rather than the calculation of tax claimed to be due, that is contested.
>
> [*Lanco*, *supra*, 21 *N.J. Tax* at 203 (footnote omitted).]

In *Quill Corp. v. North Dakota*, 504 *U.S.* 298, 301, 112 *S. Ct.* 1904, 1907, 119 *L. Ed.* 2d 91, 99 (1992), the State of North Dakota sought to impose a duty to collect a use tax on "an out-of-state mail-order house that ha[d] neither outlets nor sales representatives in the State." Quill sold office furniture by mail order catalogue and advertising, and delivered it by mail or common carrier. The Court held that, while the Due Process Clause "minimum contacts" jurisprudence did not bar the state from requiring Quill, as the seller, to collect a use tax, there was an insufficient nexus under the Commerce Clause to permit such a tax. *Quill*, *supra*, 504 *U.S.* at 313, 112 *S. Ct.* at 1913-14, 119 *L. Ed.* 2d at 101. According to Justice Stevens, "[t]he two standards are animated by different constitutional concerns and policies":

> Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him. We have, therefore, often identified "notice" or "fair warning" as the analytic touchstone of due process nexus analysis. In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual

> defendant as by structural concerns about the effects of state regulation on the national economy.
>
> [*Quill, supra*, 504 *U.S.* at 312, 112 *S. Ct.* at 1913, 119 *L. Ed.* 2d at 106.]

The Court discussed the four factors it first enunciated in *Complete Auto Transit, Inc. v. Brady*, 430 *U.S.* 274, 279, 97 *S. Ct.* 1076, 1079, 51 *L. Ed.* 2d 326, 331 (1977), to determine whether a state tax will withstand a commerce clause challenge:

> Under *Complete Auto*'s four-part test, we will sustain a tax against a Commerce Clause challenge so long as the "tax [1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State."
>
> [*Quill, supra*, 504 *U.S.* at 311, 112 *S. Ct.* at 1912, 119 *L. Ed.* 2d at 105.]

In discussing the four factors the *Quill* Court explained that "[t]he second and third parts of that analysis, which require fair apportionment and non-discrimination, prohibit taxes that pass an unfair share of the tax burden onto interstate commerce." *Quill, supra*, 504 *U.S.* at 313, 112 *S. Ct.* at 1913, 119 *L. Ed.* 2d at 107. "The first and fourth prongs, which require a substantial nexus and a relationship between the tax and state-provided services, limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce." *Ibid.* The Court stated:

> Thus, the "substantial nexus" requirement is not, like due process' "minimum contacts" requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce. Accordingly, . . . a corporation may have the "minimum contacts" with a taxing State as required by the Due Process Clause, and yet lack the "substantial nexus" with that State as required by the Commerce Clause.

[*Quill*, *supra*, 504 *U.S.* at 313, 112 *S. Ct.* at 1913-14, 119 *L. Ed.* 2d at 107 (footnote omitted).]

Accordingly, for purposes of the Commerce Clause, the *Quill* court maintained the "bright-line, physical-presence requirement [established by *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 *U.S.* 753, 87 *S. Ct.* 1389, 18 *L. Ed.* 2d 505 (1967), for imposition] of sales and use taxes." *Quill*, *supra*, 504 *U.S.* at 317, 112 *S. Ct.* at 1916, 119 *L. Ed.* 2d at 110.[2]

The Director argues that "the rationale for abandoning a physical-presence requirement for Due Process Clause purposes recognizes that businesses engage in significant levels of commercial activity in a state without ever 'setting foot' there," and businesses foresee being subject to state tax laws as a result of commercial activity directed at a particular state. The Director further contends that "[t]here is no principled reason why the Commerce Clause should require a corporation's physical presence to justify State taxation . . . provided the State can establish that the corporation derives

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[2] As will be further developed hereinafter, a careful reading of *Quill* reflects the express limitation for sales and use taxes as a matter of *stare decisis* in light of *Bellas Hess*, even though "the *Bellas Hess* rule appears artificial at its edges." *Quill*, *supra*, 504 *U.S.* at 315, 112 *S. Ct.* at 1914, 119 *L. Ed.* 2d at 108.

significant benefits from continued and deliberate economic activity in the taxing State." The Director also emphasizes that *Quill* involved vendors whose only connection with customers was by common carrier or the United States mail, but here there is a long-term contractual relationship with a related corporation that operates retail-clothing outlets throughout New Jersey.

Defendant further asserts that the agreement between plaintiff and Lane Bryant "promotes increased retail purchases of merchandise" at stores in New Jersey, and that "growth in retail sales burdens [New Jersey] by increasing traffic, requiring police and fire protection, and imposing demands on the labor pool."[3] Defendant therefore argues that this case is distinguishable from *Quill* and *Bellas Hess*, on which *Quill* relied, where they merely sent mail order catalogs into a state without obtaining the benefits and protection of state services and labor which derive from its physical presence. In this case, the Director maintains that plaintiff and its related entity, Lane Bryant, enjoy numerous benefits provided by New Jersey including: (1) "protection afforded by the New Jersey judiciary to [plaintiff 's] rights under the licensing agreement and its right to protect its trademarks and service marks"; (2) maintenance of New Jersey's highway system and production of an "educated workforce"; and (3) "police, fire and judicial protection" of

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[3] Many facts were stipulated, and we rely on the Tax Court's recitation of facts. Because we reverse the Tax Court on the Commerce Clause holding (and merely address the fundamental issue presented), we will allow further development before that court of any remaining relevant or material factual contest which may affect the taxability, determination of apportionment of income attributable to New Jersey, or tax for any particular tax year in question.

the physical property upon which Lanco's trademarks are used, even if owned by Lane Bryant.

We agree with the Director that *Quill* does not apply to taxes other than sales and use taxes, *Quill*, *supra*, 504 *U.S.* at 314, 112 *S. Ct.* at 1914, 119 *L. Ed.* 2d at 108 (stating "[w]e have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes. . . ."), and that the Corporation Business Tax may be constitutionally applied to impose a tax on plaintiff 's income from licensing fees attributable to New Jersey.

In *Geoffrey Inc. v. South Carolina Tax Comm'n*, 437 *S.E.*2d 13, 18, *cert. denied*, 510 *U.S.* 992, 114 *S. Ct.* 550, 126 *L. Ed.* 2d 451 (1993), the Supreme Court of South Carolina noted the distinction between the taxes involved in *Quill* and income taxes:

> It is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property alone is sufficient to establish nexus. *American Dairy Queen*, 93 *N.M.* at 747, 605 P.2d at 255. *See also Int'l Harvester Co. v. Wisconsin Dep't of Taxation*, 322 *U.S.* 435, 441- 442, 64 *S. Ct.* 1060, 1063-64, 88 *L.Ed.* 1373, 1379 (1944) (a state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are within the protection of the state and entitled to the numerous other benefits which it[ ] confers); *J. Hellerstein & W. Hellerstein*, *supra*, at 6.08 (any corporation that regularly exploits the markets of a state should be subject to its jurisdiction to impose an income tax even though

> not physically present). A taxpayer who is domiciled in one state but carries on business in another is subject to taxation measured by the value of the intangibles used in his business. *Curry*, 307 *U.S.* at 368, 59 *S. Ct.* at 906, 83 *L. Ed.* at 1348. We hold that by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a "substantial nexus" with South Carolina.
>
> [*Geoffrey, Inc.*, *supra*, 437 *S.E.*2d at 18.][4]

Accordingly, the South Carolina Supreme Court upheld the income tax imposed against the owner of trade names and trademarks for which Toys 'R Us paid a license fee for use in South Carolina. *Id.* at 17.

The recent and, in our view, the more persuasive authority leads us to join the jurisdictions which have followed *Geoffrey* and to uphold the tax. This is particularly true because, as the Tax Court stated, "the CBT statute is clearly intended to reach foreign corporations engaged in business activities within the state to the full extent that is constitutionally permissible." *Lanco*, *supra*, 21 *N.J. Tax* at 214, citing *Roadway Express, Inc. v. Director, Div. of Taxation*, 50 *N.J.* 471, 483, (1967), *appeal dismissed*, 390 *U.S.* 745, 88 *S. Ct.* 1443, 20 *L. Ed.* 2d 276 (1968). *See also Bendix Corp. v. Director, Div. of Taxation*, 125 *N.J.* 20, (1991) (assessment of capital gains tax on sales by corporation doing business in multiple states), *rev'd*, *sub*

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[4] In *Geoffrey* there was no commerce clause challenge based on the discrimination or unfair apportionment prongs. *Geoffrey* also rejected a due process challenge and found Geoffrey purposefully directed its activities to South Carolina by allowing the use of trademarks and intangible assets in the state. *Id.* at 17.

nom. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 *U.S.* 768, 112 *S. Ct.* 2251, 119 *L. Ed.* 2d 533 (1992).

In *A & F Trademark, Inc. v. Tolson*, 605 *S.E.*2d 187 (N.C. Ct. App. 2004), *petition for cert. filed*, 73 *U.S.L.W.* 3719 (U.S. Jun. 06, 2005) (No. 04-1625), decided since the Tax Court's opinion in this case, the North Carolina Court of Appeals upheld the assessment of corporate franchise and income taxes against wholly-owned, non-domiciliary subsidiary corporations of Limited, Inc. *Id.* at 192-93. Like the plaintiffs in the case before us, the North Carolina taxpayers were related to a clothing retailer with stores in North Carolina and contended "that the presence of their intangible property in North Carolina [as a result of license fees paid for use of trademarks] is irrelevant in light of the lack of physical presence of offices, facilities, employees and real or tangible property," and that the United States Supreme Court's opinion in *Bellas Hess* required a finding that the tax sought to be imposed by North Carolina violated the Commerce Clause. *Id.* at 193. Specifically, the taxpayers asserted that "they did not have a substantial nexus with North Carolina because they have no physical presence in [the] State." *Ibid.*

The North Carolina Court of Appeals rejected the argument because "[b]oth *Bellas Hess* and *Quill* involved attempts by a state to require out-of-state mail-order vendors to collect and pay use taxes on goods purchased within the state despite the fact that the vendors had no outlets or sales representatives in the state." *Ibid.* According to the North Carolina Court of Appeals, the Supreme Court's decision in *Bellas Hess*, " 'stands for the proposition that a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause' " to support the tax, *ibid.* (quoting *Quill*, *supra*, 504 *U.S.* at 311, 112 *S. Ct.* at 1912, 119 *L. Ed.* 2d at

106), and *Quill* ultimately concluded that, "for purposes of sales and use taxes assessed against vendors whose only contact with a state is by mail or common carrier, the substantial nexus prong of *Complete Auto* could appropriately be determined by a 'bright-line, physical presence requirement.' " *Id.* at 194, quoting *Quill*, 504 *U.S.* at 317, 112 *S. Ct.* at 1916, 119 *L. Ed.* 2d at 110.

The North Carolina Court of Appeals stated three reasons for declining to adopt the broader reading of *Quill* as requiring a physical presence for income tax purposes. *Id.* at 194-95. "First, the tone in the *Quill* opinion hardly indicates a sweeping endorsement of the bright-line test it preserved, and the Supreme Court's hesitancy to embrace the test certainly counsels against expansion of it." *Id.* at 194. This was because in its discussion of the Commerce Clause, the Supreme Court noted that "while *Bellas Hess* did not conflict with recent Commerce Clause cases, 'contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today.' " *Ibid.* (quoting *Quill*, *supra*, 504 *U.S.* at 311, 112 *S. Ct.* at 1912, 119 *L. Ed.* 2d at 105). Stated differently, "recent Commerce Clause decisions . . . signaled a 'retreat from the formalistic constrictions of a stringent physical presence test in favor of a more flexible substantive approach.' " *Ibid.* (quoting *Quill*, 504 *U.S.* at 314, 317, 112 *S. Ct.* at 1914, 1915, 119 *L. Ed.* 2d at 107, 110). According to the North Carolina Court of Appeals:

> The [United States Supreme] Court further observed the physical-presence test, though offset by the clarity of the rule, was "artificial at its edges." *Quill*, 504 *U.S.* at 315, 112 *S. Ct.* at 1914, 119 *L. Ed.* 2d at 108. In addition, the Court twice noted that in other types of taxes, it had never articulated the same physical-presence requirement adopted in *Bellas*

> *Hess*, *see Quill*, 504 *U.S.* at 314 and 317, 112 *S. Ct.* at 1914 and 1915, 119 *L. Ed.* 2d at 108 and 110, but cautioned that the failure to expand the *Bellas Hess* rule established for sales and use taxes to other types of taxes did not imply that the *Bellas Hess* rule as applied to sales and use taxes was vestigial or disapproved. *Id.* Nonetheless, the Court's choice to abstain from rejecting the *Bellas Hess* rule for sales and use taxes fails to argue persuasively that the rule should, for lack of rejection, be augmented to cover other types of tax. While the Supreme Court may ultimately choose to expand the scope of the physical-presence test reaffirmed in *Quill* beyond sales and use taxes, its equivocal reaffirmation of that test does not readily make that choice self-evident.
>
> [*A & F Trademark*, *supra*, 605 *S.E.*2d at 194.]

The North Carolina court in *A & F Trademark* further stated that the retention of the *Bellas Hess* test in *Quill* was based on the principle of *stare decisis* and the "substantial reliance" on the physical-presence test, which had "become part of the basic framework of a sizable industry." *Ibid.* (quoting *Quill*, *supra*, 504 *U.S.* at 317, 112 *S. Ct.* at 1916, 119 *L. Ed.* 2d at 110). The North Carolina court concluded that it "need look no further than the language in *Quill* to summarily dispense with the possibility that *stare decisis* plays an analogous role" in a case involving neither the use or sales tax because the Supreme Court had twice expressed that the bright-line, physical-presence requirement of *Bellas Hess* "had not been adopted in other forms of taxation." *Ibid.* Furthermore, the court dismissed the possibility that analogous substantial reliance – as discussed in *Quill* – existed in the present case "since the physical-presence requirement has never been established by judicial precedent

for other forms of taxation," and the North Carolina form of taxation was relatively new. *Ibid.*

Finally, *A & F Trademark* relied on Jerome R. Hellerstein, *Geoffrey and the Physical Presence Nexus Requirement of Quill*, 8 *State Tax Notes* 671, 676 (1995), and found "important distinctions between sales and use taxes [as compared to] income and franchise taxes 'that makes the physical presence test of the vendor use tax collection cases inappropriate as a nexus test' " for taxation beyond the use and sales taxes. *A & F Trademark, supra*, 605 *S.E.*2d at 194-95. The court quoted the Hellerstein article to the effect that the " '[United States]' Supreme Court has made it clear that the presence of the recipient of income from intangible property in a state is not essential to the state's income tax on income of a nonresident.' " *Id.* at 194- 95 (quoting *Hellerstein, supra*, at 676).

Thus, the North Carolina court in *A & F Trademark* followed the determination in *Geoffrey*, which our Tax Court rejected, and concluded:

> [W]e reject the contention that physical presence is the *sine qua non* of a state's jurisdiction to tax under the Commerce Clause for purposes of income and franchise taxes. Rather, we hold that under facts such as these where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause. *Accord Geoffrey*, 437 *S.E.*2d at 18 (holding that "by licensing intangibles [to Toys 'R Us, an affiliated operating store,] for use in [South Carolina] and deriving income from their use [t]here, Geoffrey ha[d] a 'substantial nexus' with South Carolina"); *Kmart* [*Properties, Inc. v.*

> *Taxation and Revenue Dep't of New Mexico*, No. 21, 140 at 13 (N.M. Ct. App. Nov. 27, 2001)] at 15 (holding that "the use of KPI's [the wholly-owned trademark holding company licensor] marks within New Mexico's economic market, for the purpose of generating substantial income for KPI, establishe[d] a sufficient nexus between that income and the legitimate interests of the state and justifie[d] the imposition of a state income tax").
>
> [*A & F Trademark, supra*, 605 *S.E.*2d at 195.]

Of particular interest, the court addressed this very case and stated:

> We are also cognizant of the holding of the New Jersey Tax Court in a case involving one of the taxpayers before this Court on the same issue. *Lanco, Inc. v. Dir., Div. of Tax'n.*, 21 *N.J. Tax* 200 (2003). In that case, the New Jersey Tax Court concluded "that the physical presence of the taxpayer or its employee(s), agent(s), or tangible property in a jurisdiction has been and remains an necessary element for a finding of substantial nexus under the Commerce Clause of the United States Constitution." *Id.*, 21 *N.J. Tax* at 214. We respectfully disagree. Summarizing the salient portions of that opinion, the New Jersey Tax Court (1) found it "illogical" to have a physical presence as a constitutional necessity for sales and use taxes but not for income tax, (2) opined physical presence, as a prerequisite to state taxation of income, was "fully consistent with and strongly suggested by the Commerce Clause cases decided before *Quill* "because the circumstances of those cases involved taxpayers who were physically present in the state

attempting to impose the tax, and (3) stated "other state court cases decided since *Quill* do not follow the *Geoffrey* rule." *Id.*, 21 *N.J. Tax* at 208-09.

Regarding the first reason given by the New Jersey Tax Court, the *Quill* opinion itself twice notes the singularity of its adoption and reaffirmation of the physical-presence test for Commerce Clause nexus in the arena of sales and use taxes. Moreover, as illustrated by our analysis herein, we disagree with the New Jersey Tax Court that there do not exist certain distinctions between the tax at issue in *Quill* and those considered in the instant case that justify divergent treatment. Regarding the second reason, we do not accord the same import to pre-*Quill* cases in which it was far more likely that a taxpayer would be required to be physically present (in the traditional commercial sense) in a state in order to earn income there. Lastly, the third reason espoused by the New Jersey Tax Court rings hollow. For example, in discussing *General Motors Corp. v. City of Seattle*, 107 *Wash. App.* 42, 25 *P.*3d 1022 (2001), *cert. den.*, 535 *U.S.* 1056, 122 *S. Ct.* 1915, 152 *L. Ed.* 2d 825 (2002), the New Jersey Tax Court dismisses the Washington appellate court's express declaration that it "decline[d] to extend *Quill's* physical presence requirement" to a business and occupation tax on the basis that the taxpayers in that case had a physical presence in that jurisdiction. The corporation's physical presence can hardly serve to obscure the Washington Court's unequivocal choice to stand with *Geoffrey's* containment of the *Quill* physical-presence test. More importantly, any assertion that *Geoffrey* has not been, by and large, approved of in subsequent cases cannot be sustained. *See* J. Hellerstein & W.

> Hellerstein, State Taxation, Para. 6.11[3] at 6-16 (Warren, Gorham & Lamont, 3d ed. Cum. Supp. 2004) (comprehensively analyzing judicial and administrative post- *Geoffrey* developments and summarizing that, although mixed, "judicial and administrative reaction to the opinion across the country has generally supported [*Geoffrey's*] position that *Quill's* physical-presence test of Commerce Clause nexus does not extend to income taxes").
>
> [*Id.* at 195-96 (footnote omitted).]

Similarly, in *Secy, Dep't of Revenue v. Gap (Apparel), Inc.*, 886 *So.*2d 459, 461-62 (La. Ct. App. 2004) (per curiam) (hereinafter "*Gap*"), the Louisiana Court of Appeals held that the state could impose a corporate income tax on Gap Apparel, a Delaware corporation, in circumstances involving intangible property almost identical to the facts before us. Apparel authorized the Gap and its affiliates to use registered trademarks, trade names and service marks for which it received "a royalty based on the net sales of the licensed products." *Id.* at 461. The court upheld the tax despite the absence of real or personal property, employees or other presence in Louisiana and the absence of the entry of any licensing agreement there, *id.* at 462, stating:

> [I]t is clear that the marks licensed by Apparel have been used in Louisiana in such a way as to become an integral part of the licensees' businesses in this state. Numerous marks (*i.e.* Gap, Baby Gap, Gap Kids, Pro Fleece) have been licensed by Apparel and used by the licensees to conduct and promote their businesses in this state. Clearly, the intangibles have acquired a business situs in Louisiana and are subject to taxation in this state.

[*Gap, supra*, 886 *So.*2d at 462.]

We are satisfied that the physical presence requirement applicable to use and sales taxes is not applicable to income tax and that the New Jersey Business Corporation Tax may be constitutionally applied to income derived by plaintiff from licensing fees attributable to New Jersey.

Accordingly, we reverse the judgment of the Tax Court and remand for further proceedings relating to the tax imposed consistent with this opinion.[5]

I hereby certify that the foregoing is
a true copy of the original on file in my office
/s/_____
ACTING CLERK OF THE APPELLATE DIVISION

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[5] It is unclear from the argument before us as to whether the unresolved dispute involves more than one year, *see Lanco, supra*, 21 *N.J. Tax* at 203-04 n.1, and other issues not disposed of by stipulation. As noted, *supra*, at 7, footnote 2 of this opinion, we have resolved the critical issue under review, and we remand to the Tax Court for resolution of all open issues or questions which arise in light of our judgment. However, because of the constitutional issue involved, we stay the remand if plaintiff files a timely direct appeal or, to be safe in case the Supreme Court does not consider the issue "substantial," *see R.* 2:2-1(a)(1), pending decision on a petition for certification.

APPENDIX C

TAX COURT OF NEW JERSEY

DOCKET NO. 005329-97

LANCO, INC.	:	
Plaintiff,	:	
v.	:	OPINION
DIRECTOR, DIVISION OF TAXATION,	:	
Defendant.	:	

Decided: October 23, 2003

Paul H. Frankel, Hollis L. Hyans, Craig B. Fields, of Counsel, and Amy F. Nogid, of Counsel, for Plaintiff
(Morrison & Foerster LLP, attorneys).
Charles M. Costenbader, of Counsel, for Plaintiff
(McCarter & English, LLP, attorneys).

Patrick DeAlmeida, for Defendant
(Peter C. Harvey, Attorney General of New Jersey).

Charles H. Friedrich, of Counsel, for Amicus Curiae New Jersey State Chamber of Commerce
(Stryker, Tams & Dill LLP, attorneys).

PIZZUTO, J.T.C.

This case presents the question of whether New Jersey may constitutionally subject a foreign corporation to the Corporation Business Tax (*N.J.S.A.* 54:10A-1 *et seq.*, "the CBT"), where the corporation has no physical presence in the state and derives income from a New Jersey source only pursuant to a license agreement with another corporation that conducts a retail business here.

Plaintiff Lanco, Inc., ("Lanco") is a Delaware corporation that owns certain intangible property (trademarks, trade names and service marks). The parties have stipulated that Lanco has no offices, employees, or real or tangible property in New Jersey. Lanco licenses Lane Bryant, Inc., ("Lane Bryant") to utilize the intangible property in the conduct of Lane Bryant's retail operations, including those in New Jersey, and in return receives royalty payments from Lane Bryant. Lanco and Lane Bryant are affiliated corporations, but the common ownership is not material to the constitutional issue concerning the determination by the defendant, Director of the Division of Taxation ("Director"), that activity under the license agreement makes Lanco subject to taxation in New Jersey. It is the determination that Lanco is obliged to file under the CBT, rather than the calculation of tax claimed to be due, that is contested.[1]

State taxation of entities engaged in interstate commerce must comport with the Due Process and Commerce Clauses of the United States Constitution. In the leading case of

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[1] The original determination required filings beginning in 1983. During the pendency of the action, however, the parties have stipulated that issues concerning certain reporting periods have been resolved and that the claims in this action are amended to address only the year ending January 31, 1998. The court has allowed the amendment.

Complete Auto Transit v. Brady, 430 *U.S.* 274, 97 *S.Ct.* 1076, 51 *L.Ed.*2d 326 (1977), the Supreme Court articulated the standard to determine whether, in the absence of Congressional action (when the clause is considered "dormant"), a particular instance of state taxation of interstate commerce is permitted under the Commerce Clause. *U.S. Const.* art. I, § 8, cl. 3. The Court formulated a four-part test that permits taxation "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." 430 *U.S.* at 279.

Until the decision in *Quill Corp. v. North Dakota*, 504 *U.S.* 298, 112 *S.Ct.* 1904, 119 *L.Ed.*2d 91 (1992), it was generally considered that the requirement of the Due Process Clause, *U.S. Const.* Amend. XIV, § 1, that an entity have certain minimum contacts with a taxing jurisdiction to support the imposition of a tax was not different from the substantial nexus component of the Commerce Clause standard. In *Quill*, however, the Supreme Court uncoupled the Due Process Clause analysis from the nexus test under the Commerce Clause. *Quill* concerned the use tax collection obligation[2] of a mail-order vendor of office supplies that had

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[2] States that impose a sales tax on retail transactions occurring within the state typically also impose a "compensating" use tax on the use of property whose sale in the jurisdiction would be taxable, when a sales tax has not been collected. *See N.J.S.A.* 54:32B-6. The litigation concerning mail-order vendors deals with the use tax collection obligation, rather than with the liability of the vendors to income taxation by jurisdictions into which they sell, because Congress has immunized mail-order vendors, among others, from income taxation by those jurisdictions. P.L. 86-272 (1959), codified at 15 USCA §§ 381 to 384. This statute was enacted in response to the Supreme Court's decision in *Northwestern States Portland Cement Co. v. Minnesota*, 358 *U.S.* 450, 79 *S.Ct.* 357, 3

no retail outlets or sales force in North Dakota and that shipped its products into that state by common carrier. The Court addressed the continuing vitality of its decision in *National Bellas Hess Inc. v. Department of Revenue of Ill.*, 386 *U.S.* 753, 87 *S.Ct.* 1389, 18 *L.Ed.*2d 505 (1967), which had held that a mailorder vendor may not constitutionally be required to collect from its customers a use tax imposed by the state within which its product is delivered, unless the vendor has a physical presence, more than *de minimis*, in that state. The presence may be associated with activities totally unrelated to the sale. Thus, the presence of offices handling advertisements in a publication will support the imposition of a use tax collection responsibility for items sold by the publisher. *Nat'l Geographic Soc. v. Cal. Bd. of Equalization*, 430 *U.S.* 551, 97 *S.Ct.* 1386, 51 *L.Ed.*2d 631 (1977). Moreover, the physical presence requirement may be satisfied by independent contractors who solicit sales, assist retailers or service the product sold. *See Scripto, Inc. v. Carson*, 362 *U.S.* 207, 80 *S.Ct.* 619, 4 *L.Ed.*2d. 660 (1960).

Quill determined that the *Bellas Hess* result remained sound, but as a matter of Commerce Clause jurisprudence only and not as a requirement of the Due Process Clause. Recognizing that a quarter-century of adjudication since *Bellas Hess* had produced a conception of due process in terms of minimum contacts, reasonable notice and basic fairness, the court concluded that North Dakota's assertion of an obligation on the part of *Quill* to collect use tax comported with due process. The majority (Justice Stevens joined by Chief Justice Rehnquist and Justices Blackmun, O'Connor and Souter) found, however, that the Commerce Clause

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*L.Ed.*2d 421 (1959), permitting appropriately apportioned state taxation of activities exclusively in furtherance of interstate commerce.

requirement of substantial nexus embodied other constitutional considerations:

> Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him. We have, therefore, often identified "notice" or "fair warning" as the analytic touchstone of due process nexus analysis. In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy. Under the Articles of Confederation, state taxes and duties hindered and suppressed interstate commerce; the Framers intended the Commerce Clause as a cure for these structural ills.
> . . . . Thus, the "substantial nexus" requirement is not, like due process' "minimum contacts" requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce. Accordingly, contrary to the State's suggestion, a corporation may have the "minimum contacts" with a taxing State as required by the Due Process Clause, and yet lack the "substantial nexus" with that State as required by the Commerce Clause. [504 *U.S.* at 312-13.]

The determination that physical presence remains a requirement under the Commerce Clause for the imposition of a use tax collection responsibility rests to a significant extent on *stare decisis* principles. The majority opinion observed that "the *Bellas Hess* rule has engendered

substantial reliance and has become part of the basic framework of a sizable industry." 504 *U.S.* at 317. Moreover, it noted that the "underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve." *Id.* at 318 (footnote omitted). Nevertheless, the decision does not simply reflect deference to precedent and recognition of Congressional authority. The majority clearly undertook an analysis of the physical presence requirement on its own merits. It concluded "[w]hile contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, *Bellas Hess* is not inconsistent with *Complete Auto* and our recent cases." *Id.* at 311.

The opinions of the other Justices underscore that the majority found continuing value in the requirement of physical presence for constitutional exercise of State taxing power under the Commerce Clause. Justice White concurred with the majority's due process analysis and would have applied the same standard for the substantial nexus inquiry under the Commerce Clause. He would have overruled *Bellas Hess* and given it "the complete burial it justly deserves." *Id.* at 322 (White, J., concurring in part, dissenting in part). Justice Scalia, joined by Justices Kennedy and Thomas, concurred in the result, but expressly noted that he "would not revisit the merits of that holding, but would adhere to it on the basis of *stare decisis*." *Id.* at 320 (Scalia, J., concurring).

The decisive question in this case is whether the physical presence requirement confirmed in *Quill* under the Commerce Clause applies simply to the use tax collection obligation directly at issue in that case, or whether it is also a necessary element of substantial nexus for the imposition of a state income or franchise tax. The *Quill* majority opinion

does not give an unambiguous answer to this question. In at least two places, the opinion observes that in cases concerning other types of taxes the Supreme Court has not articulated a physical presence requirement 504 *U.S.* at 314, 317. The opinion acknowledges however, that the Commerce Clause precedents considered by the North Dakota Supreme Court in sustaining a collection obligation for Quill involved businesses that were physically present in the taxing state. *Id.* at 314. Those cases were therefore, the court noted, consistent with *Bellas Hess.*

This question has been addressed both in litigation and in academic discussion subsequent to *Quill.* The earliest decision of a state court of last resort is *Geoffrey, Inc. v. South Carolina Tax Com'n*, 313 *S.C.* 15, 437 *S.E.*2d 13 (1993), *cert. den.* 510 *U.S.* 992, 114 *S.Ct.* 550, 126 *L.Ed.*2d 451 (1993). The *Geoffrey* fact pattern is materially indistinguishable from this case. Geoffrey, Inc., a wholly owned subsidiary of Toys R Us, Inc., was a Delaware corporation without property or employees in South Carolina. It owned trademarks and trade names that it licensed Toys R Us to use in that state. Toys R Us made royalty payments to Geoffrey and deducted those payments from income in determining its South Carolina income tax obligation. The South Carolina tax authorities initially disallowed the deduction, but eventually contended that Geoffrey was independently subject to taxation, notwithstanding that Geoffrey had no physical presence in the state. The South Carolina Supreme Court sustained this contention, commenting in the course of its decision that "[t]he net effect of this corporate structure has been the production of 'nowhere' income that escapes all state income taxation." 437 *S.E.*2d at 17, n.1.

The thesis that *Geoffrey* is correctly decided is comprehensively developed in two articles by Michael T.

Fatale, a tax attorney with the Massachusetts Department of Revenue: *Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property and the State Taxation of Income*, 23 *Hofstra L. Rev* 407 (1994) and *State Tax Jurisdiction and the Mythical "Physical Presence" Constitutional Standard*, 54 *Tax Law* 105 (2000). The interpretation of *Quill* adopted in *Geoffrey* and advanced by the cited articles is a necessary component of the Director's argument in this case. It considers that *Quill* merely establishes a safe harbor with respect to the use tax collection obligation for vendors that do not have a physical presence in a state where their products are delivered. In other words, if a vendor does no more than solicit orders from outside the state and ship goods into the state by mail or common carrier, the vendor is not obliged to collect the state's use tax from its customers. Where the issue is not use tax collection, but liability for state taxation of income, it is argued that *Quill* permits a finding of liability by virtue of an intentional exploitation of the state's market without physical presence in the state.

This argument is not persuasive. In the first place, it does not appear that the differences between the use tax collection obligation, on the one hand, and liability for income taxation, on the other, are so significant as to justify a different rule for each concerning physical presence as an element of Commerce Clause nexus. Next, the Supreme Court cases decided before *Quill* strongly suggest that physical presence is a necessary element of nexus for income taxation. Finally, other state court cases decided since *Quill* do not follow the *Geoffrey* rule.

As noted previously, the Supreme Court's decision in *Quill* to retain the physical presence requirement rested on more than the principles of *stare decisis* and the mailorder industry's reliance on the *Bellas Hess* rule. The Court spoke of the "benefits of a clear rule . . . [that] firmly establishes the

boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes." 504 *U.S.* at 315. It is difficult to see distinctions that give virtue to physical presence as a necessary element of nexus in this area and not for purposes of income taxation. The *Quill* majority noted the discussion in *Bellas Hess* that potential imposition of sales taxes by more than 6000 jurisdictions raised a prospect of "many variations in rates of tax, in allowable exemptions and in administrative and record-keeping requirements" and "a wealth of complicated obligations." 504 *U.S.* at 313, n.6, quoting *Bellas Hess*, *supra* at 759-60. Even on the supposition that these complexities characterize use tax collection more than income tax liability, the record-keeping and classification tasks, considered complicated and onerous in 1967 when *Bellas Hess* was decided, are considerably less difficult under contemporary data-processing technology. *See Quill, supra*, 504 *U.S.* at 332 (White, J., concurring in part, dissenting in part). The use tax collection obligation does not, to put it plainly, seem significantly more burdensome than the liability to pay an income tax. If physical presence is a constitutional necessity for one, it is illogical that it should not be for both.

The conclusion that physical presence is necessary to support state taxation of income is fully consistent with and strongly suggested by the Commerce Clause cases decided before *Quill*. *Complete Auto* establishes a standard that can fairly be called a balancing test. It does not articulate the nexus component of the test in terms of physical presence, or any particular bright-line requirement. Nevertheless, the nexus question by its very nature is analyzed in terms of objective factors like presence. The *Quill* majority, moreover, noted that the precedents cited by the North Dakota Supreme Court concerned taxpayers physically present in the taxing state. In the use tax context, *Quill* establishes that physical presence, when coupled with the filling of orders from out-

of-state, tips the balance in favor of the collection obligation. With respect to income taxation, the question seems to be the sufficiency of other factors beyond physical presence, which is taken as a given, to establish taxing jurisdiction.

In propounding the thesis that Commerce Clause nexus does not require some element of physical presence, the articles cited above acknowledge the absence of precedent at the Supreme Court level sustaining imposition of an income tax on an entity without tangible property or other physical presence in the taxing jurisdiction. The earlier article approvingly analyzes the *Geoffrey* decision and argues for wide application of its reasoning. It proposes that the business-situs rule may be invoked to establish nexus for taxation on the basis of the use of intangible property in the taxing state. The business-situs rule, applied in several cases decided nearly a century ago, permits intangibles to be assigned a tax situs in a state where the owner is not physically present. The cases concerned *ad valorem* property taxation, and the issue was due process. The article claims support from only one income tax case decided by the United States Supreme Court, *New York ex. rel. Whitney v. Graves*, 299 *U.S.* 366, 57 *S.Ct.* 237, 81 *L.Ed.* 285 (1937). *Whitney* is also a due process case, in which New York was found to have jurisdiction to tax a Massachusetts resident on income from the sale of a right derived from a seat on the New York Stock Exchange.

The second article defends the proposition that the *Quill* requirement of physical presence applies only in the use tax collection context and discusses state court litigation subsequent to *Quill*. It demonstrates that there has been considerable activity, especially since the decision in *Geoffrey*. Nevertheless, South Carolina remains the only state which has found nexus without physical presence. The *Geoffrey* holding, of course, is binding precedent only in

South Carolina. The Supreme Court's denial of *certiorari* does not address the merits of the decision. *Hughes Tool Co. v. Trans World Airlines, Inc.*, 409 *U.S.* 363, 365, 93 *S.Ct.* 647, 34 *L.Ed.*2d 577 (1973). *See also Ponte v. Real*, 471 *U.S.* 491, 502, 105 *S.Ct.* 2192, 85 *L.Ed.*2d 553 (1985) (Stevens, J., concurring in part). In its discussion of the Commerce Clause, *Geoffrey* recites the four-part test of *Complete Auto.* Then, the opinion summarily concludes, in a footnote, that in *Quill* the Supreme Court "revisited the physical presence requirement of *Bellas Hess* and while reaffirming its validity as to *sales and use taxes*, noted that the physical presence requirement had not been extended to other types of taxes." 437 *S.E.*2d at 23, n.4. The opinion goes on to declare that "[i]t is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property alone is sufficient to establish nexus." *Id.* at 23. In support of the proposition, it cites a New Mexico state court decision and the U.S. Supreme Court decision in *International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 *U.S.* 435, 441-42, 64 *S.Ct.* 1060, 88 *L.Ed.* 1373 (1944).

The *International Harvester* decision concerned a due process challenge by a foreign corporation doing business in Wisconsin to a state statute imposing a tax on that portion of dividends distributed by both domestic and foreign corporations as was derived from income earned in Wisconsin. The tax was imposed on the corporation, which was required to deduct the amount of the imposition from the dividends distributed to individual shareholders, who thus bore the burden of the tax. The Supreme Court upheld the tax, concluding that "a state has constitutional power to make a levy upon a corporation, measured by so much of its earnings from within the state as it distributes in dividends, and to make the taxable event the corporation's relinquishment of the earnings to its stockholders." 322 *U.S.*

441. In these circumstances, the Court declared "[p]ersonal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them." *Id.* The broad proposition which *Geoffrey* takes from *International Harvester* that "a state may tax such part of the income of a nonresident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are within the protection of the state and entitled to the numerous other benefits which it confers" is in the nature of dictum. 437 *S.E.*2d at 23.

The only other decision cited in the Commerce Clause section of *Geoffrey* is *Curry v. McCanless*, 307 *U.S.* 357, 59 *S.Ct.* 900, 83 *L.Ed.* 1339 (1939). This case concluded that due process permits an inheritance or succession tax to be imposed, with respect to a decedent's disposition of intangible assets held in trust, by both the decedent's state of domicile and the state where the trustee is found. Neither *Curry v. McCanless* nor *International Harvester* directly addressed the Commerce Clause and in each case physical presence, in the one instance of the trustee and in the other of the corporation, was an essential factor in the finding of jurisdiction to tax. The authorities cited by the South Carolina Court do not support its conclusion that Commerce Clause nexus may be found absent physical presence ascribable to a taxpayer.

The question of the necessity of physical presence for Commerce Clause nexus has been addressed in other state court decisions after *Quill* and *Geoffrey*. None of them find nexus absent physical presence. *J.C. Penney Nat'l Bank v. Johnson*, 19 *S.W.*3d 831 (Tenn. App. 1999), moreover, clearly rejects the reasoning of *Geoffrey*. The Tennessee court concluded that income realized by a Delaware banking

corporation from credit card activity in Tennessee was not subject to Tennessee's franchise and excise taxes. The court observed that it could find no basis to differentiate between the use collection obligation addressed in *Quill* and the taxes imposed by Tennessee. Without specifically addressing *Geoffrey*, the decision found that under *Quill* physical presence is necessary for a finding of Commerce Clause nexus.

In another case, on facts like those in *Geoffrey* and the instant matter, the Maryland Court of Appeals reversed the holding of the Maryland Tax Court that a Delaware corporation, affiliated with a local retailer, is not subject to taxation where its only contact with Maryland is a license agreement with the retailer. *Comptroller of the Treasury v. SYL Inc.*, 375 *Md.* 78, 825 *A.*2d 399 (2003). In doing so, the Court did not find that the license of intangible property for use within a state, without more, establishes Commerce Clause nexus for taxation of the licensor by the state within which the property is used. Rather, it concluded that the licensing corporation had no economic substance as a separate business entity, apart from the licensee. Although the court cited *Geoffrey* favorably, it also invoked the decision in *Syms Corp. v. Comm'r. of Revenue*, 436 *Mass.* 505, 765 *N.E.*2d 758 (2002), in which the deduction of royalty payments to an affiliated corporation was disallowed in the computation of a retailer's taxable income because the payments resulted from a "sham transaction." The Maryland decision is not, therefore, an unqualified adoption of *Geoffrey*, and it does not support the Division's contention in this matter.

Other decisions taking note of *Geoffrey* do not directly address the question of whether physical presence is required to establish nexus. *Truck Renting & Leasing Assn., Inc. v. Comm'r of Revenue*, 433 *Mass.* 733, 746 *N.E.*2d 143 (2001),

sustains the imposition of the Massachusetts corporate excise tax to a foreign corporation that entered into lease agreements under which its trucks were operated in Massachusetts by the lessees. Although the issue of nexus without physical presence is noted in passing, the decision turns on the anticipated presence and use of the lessor's tangible property in the state. *Couchot v. State Lottery Comm'n.*, 74 *Ohio* St. 417, 659 *N.E.*2d 1225 (1996), holds a non-resident liable for state income tax on Ohio lottery winnings. Citing *Geoffrey*, the court considered that the physical presence requirement of *Quill* was inapplicable in the case. Nevertheless, the decision notes that the taxpayer was physically present in Ohio in both purchasing and redeeming the winning lottery ticket. *General Motors Corp. v. City of Seattle*, 107 *Wash.App.* 42, 25 *P.*3d 1022 (2001) *rev. den.* 145 *Wash.*2d 1014, 35 *P.*3d 381 (2001), *cert. den.* 525 *U.S.* 1056, 122 *S.Ct.* 1915, 152 *L.Ed.*2d 815 (2002), concerns a local business and occupation tax, to which General Motors and Chrysler Corporations were found subject because, among other factors, their sales, service and parts representatives made regular visits to Seattle dealerships. In its discussion of *Quill* and *Geoffrey*, the court distinguished the tax at issue from both sales and use taxes and corporate franchise taxes and concluded that "[w]e decline to extend *Quill's* physical presence requirement in this context." 25 *P.*2d at 1022. It is clear, however, that the automobile manufacturers had a physical presence in the taxing jurisdiction. Finally, in *Acme Royalty Co. v. Director of Revenue*, 96 *S.W.*3d 72 (Mo. 2002) the Missouri Supreme Court, in a 4-3 decision interpreting state law, found that the state's corporate income tax statute did not reach income received by foreign corporations from licenses of trademarks, trade names and patents to related corporations operating in Missouri. The dissenting judges, invoking *Geoffrey* with respect to federal constitutional questions, would have found the corporations subject to tax.

This analysis leads to the conclusion that the physical presence of the taxpayer or its employee(s), agent(s), or tangible property in a jurisdiction has been and remains a necessary element for a finding of substantial nexus under the Commerce Clause of the United States Constitution. This constitutional issue must be reached, although Lanco advances an alternative argument that subjecting it to tax on the basis of its license agreement with Lane Bryant is not consistent with the terms of the New Jersey Corporation Business Tax Act (*N.J.S.A.* 54:10-A *et seq.*) The statutory argument fails because the CBT statute is clearly intended to reach foreign corporations engaged in business activities within the state to the full extent that is constitutionally permissible. *Roadway Express, Inc. v. Dir., Division of Taxation*, 50 *N.J.* 471, 483 (1967) *appeal dism,* 390 *U.S.* 745, 88 *S.Ct.* 1443, 20 *L.Ed.*2d 276 (1968).

The dispositive conclusion under the Commerce Clause also renders unnecessary extended discussion of other questions presented and expert testimony produced. Some discussion of those matters, however, is useful for an understanding of this decision. Lanco has argued, in particular, that not only the Commerce Clause, but also the Due Process Clause, immunizes it from taxation in New Jersey. Yet it is impossible to conclude that its agreement with Lane Bryant does not satisfy the *Quill* due process standard in that Lanco has purposefully availed itself of the benefits of an economic market in New Jersey. *See Quill*, 504 *U.S.* at 307-08. Similarly, any contention that other elements of the four-part *Complete Auto* test are not satisfied is without merit. Since this case concerns not an assessment, but a determination of responsibility to file, the fair apportionment element of the *Complete Auto* test is not raised as an issue. The remaining elements concern discrimination and fair relation to benefits provided by the

state. It is beyond question that the state seeks to tax license income of both domestic and foreign corporations and among the latter class to tax both those physically present and those not. There is simply no distinction made upon which a discrimination claim can be founded. As to fair relationship to services, it is clear that Lanco's intangibles are utilized in the conduct of Lane Bryant's retail business. Although it is not physically present in the state, Lanco clearly enjoys the same benefits provided to Lane Bryant.

Both parties presented testimony of economic experts. David Wildasin, Professor of Economics at Vanderbilt University testified as part of plaintiff's case. He concluded that it is undesirable on economic grounds for states to tax the income of corporations that have no physical presence in the taxing state. He considered it important that states have revenue mechanisms enabling them to tax entities that impose costs on the states to provide public services. In Wildasin's view, businesses that are physically present impose such costs, while those without physical presence do not. A licensor of intangibles like Lanco receives, the expert acknowledged, an indirect benefit from the state in which its licensee conducts business, but that benefit does not support taxation. Taxation based upon indirect benefit, in his opinion, would produce adverse consequences in the form of multiple taxation, discouragement of commerce, export of tax burden, and potentially disparate taxation of separate economic sectors; while taxation based on physical presence would have no adverse consequences.

Defendant presented the testimony of James Kearl, Professor of Economics at Brigham Young University. He observed that there is no necessary relationship between the magnitude of the costs imposed on a state by a given taxpayer's activity in the state and the amount of revenue collected from that taxpayer. He considered that Lanco's

licensure of intangibles for use in New Jersey imposes costs on the state because it generates economic activity that increases the demand for public services; and he further considered that Lanco benefits from this activity, since it receives fees that increase with sales. Kearl concluded that the imposition of a corporate income tax on a licensor like Lanco is warranted by economic factors and that it would produce no substantial distortions of economic behavior. He regarded broadening the tax base to include entities without physical presence in the state as permitting the lowering of the tax rate and the reduction of the overall impact of the corporation tax on economic incentives and behavior.

Plaintiff also offered the testimony of Richard D. Pomp, Professor of Law at the University of Connecticut. Pomp is one of the leading academic authorities in state and local taxation and was qualified as an expert in tax policy. As such, he enumerated six principles of tax policy that he regarded as representing the values inherent in the commerce clause: desirability of a clear or "bright-line" test, consistency with settled expectations, reduction of litigation and promotion of interstate investment, nondiscriminatory treatment of the service sector, avoidance of multiple taxation, and efficiency of administration. He concluded that a requirement for physical presence as an element of Commerce Clause nexus advances each of these principles to a greater extent than a rule establishing nexus on the basis of use of intangible property. Pomp also found no reason to distinguish between the use tax collection obligation, directly involved in *Quill*, and the obligation to pay the corporate tax at issue here in terms of considerations relating to nexus. Finally, he described how the method of combined reporting for corporate taxation would permit taxation of income received by a foreign corporation for use of intangible property in the taxing state by a related corporation, even

under a nexus rule requiring physical presence, and he endorsed combined reporting as sound tax policy.[3]

Economic and tax policy considerations are unquestionably valid material for the Supreme Court to consider in its task of constitutional adjudication. Those considerations are also appropriately addressed by the Legislature when it formulates the statutory scheme of taxation. Expert testimony does not, however, bear upon the question of whether the requirement of physical presence for Commerce Clause nexus is, following *Quill*, applicable beyond the use tax collection situation. That is a question of the interpretation of case law. Once it is determined that the precedents continue to require physical presence for nexus, there is no further question in this case for expert testimony to address.

A question of retroactivity has also been raised in the *amicus curiae* brief filed by the New Jersey Chamber of Commerce. It is argued that the regulation adopted by the Director expanding the definition of doing business under the Corporation Business Tax (under which the determination at

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[3] Combined reporting is distinguished from separate-entity reporting. Under the latter, each corporation or other business entity reports only its own income, while under the former a combined report is submitted for a parent corporation and all its subsidiaries that disregards inter-company transactions. In either system, all income of any unitary business conducted in whole or in part within the State is reported, and the taxable portion is determined by an apportionment formula. *See* Pomp & Oldman, *State & Local Taxation*, 10-29 to 10-36 (3d ed. 2000). *Allied-Signal Inc., v. Director, Div. of Taxation*, 504 *U.S.* 768, 112 *S.Ct.* 2251, 119 *L.Ed.*2d 533 (1992) discusses the unitary business concept in its application to New Jersey as a separate-entity jurisdiction.

issue was made) should be applied only prospectively. The regulation, amending *N.J.A.C.* 18:7-1.9 to include the licensure of trademarks to retailers operating in New Jersey was adopted in 1996. 28 *N.J.R.* 4795(a). It is unquestionably the Director's response to the question of the necessity of physical presence for nexus in light of *Quill* and *Geoffrey*. This decision concludes that physical presence is a necessary element for Commerce Clause nexus after *Quill*. Moreover, the tax period that remains in dispute between the parties begins after the effective date of the amendment. The retroactivity question is therefore moot.

Nevertheless, if physical presence were no longer a necessary element for nexus, retroactive application of a rule permitting a finding of nexus without physical presence would appear problematical. Regulations interpreting the terms of a tax statute do not by their own force impose taxes, and by their nature they are ordinarily retroactive to the statute's effective date. *Sharps, Pixley, Inc. v. Director, Div. of Taxation*, 16 *N.J. Tax* 626, 640 (Tax 1997); *General Bldg. Prod. Corp. v. Director, Div. of Taxation*, 14 *N.J. Tax* 232, 247 (Tax 1994) *aff 'd*, 15 *N.J. Tax* 213 (App. Div. 1995). Where, however, a tax regulation is premised on a perceived change in federal constitutional law, the same considerations do not necessarily apply. New Jersey has settled precedent, antedating *Quill* and *Geoffrey*, that bases nexus on physical presence. *Avco Financial Services Consumer Discount Company, One, Inc. v. Director, Div. of Taxation*, 100 *N.J.* 27, 38 (1985) (finding "substantial physical presence"); *Chemical Realty Corp. v. Director, Div. of Taxation*, 5 *N.J. Tax* 581, 612 (Tax 1983), *aff'd* 6 *N.J.* 448 (App. 1984). A finding of nexus without physical presence would clearly reflect a change in applicable law. In these circumstances, this court could reasonably conclude that the novelty of the change and the reliance interests of taxpayers under the former interpretation justify confining the new rule to

application only after the effective date of the amendment to the regulation. *Cf. State Troopers Fraternal Ass'n of N.J., Inc. v. State*, 149 *N.J.* 38 (1997).

It is appropriate to note, in addition, certain considerations that arise from the particular facts of this case. The plaintiff, while not physically present in the state, does have a direct long-term contractual relationship with a related entity clearly doing business in New Jersey. The case does not therefore concern isolated transactions, indirect connections or distant actors who cannot anticipate where the products of their effort, tangible or intangible, may come to be employed. If physical presence were not a requirement, nexus might be found in the circumstances there is no direct contractual relationship between the producer of property and its user in this state. There are other factors besides physical presence that can limit nexus findings and prevent taxation of remote parties. Certainly the due process standards of notice and fair warning will continue to hold. This decision concludes, however, that physical presence continues to be a requirement of the Commerce Clause.

This case and *Geoffrey*, as well as certain decisions in other states dealing with the necessity of physical presence for nexus, concern corporations organized to hold intangible property used in a retail or other business by an affiliated corporation. They are usually incorporated in jurisdictions that do not tax them on the receipt of license or royalty income from the operating company, which takes a deduction from its own income for the royalty payment as an ordinary business expense. The result is that the single enterprise which includes the two corporations receives income, not taxable under traditional nexus rules in any jurisdiction, which the *Geoffrey* court characterized as "nowhere income." Among the reasons, and perhaps the decisive reason, for placing ownership of intangibles in a separate corporation, is

the avoidance of taxation. Michael A. Lisi, Practicing Law Institute, *Intracorporate Licensing: A Domestic Trademark Holding Company Example*, (PLI Order No. G4-4033, Mar. 1998).

Legitimate means to minimize taxation are, of course, the prerogative of any business and perhaps the dictate of market-place competition. It is a familiar principle that a taxpayer is bound by its choice among different structures or transactions and must pay more tax, if it has chosen one means rather than another that would accomplish the same result with lower tax consequences. *General Trading Co. v. Director, Div. of Taxation*, 83 *N.J.* 122 (1980). The taxing authority is similarly bound where the taxpayer has chosen shrewdly.

This decision determines that the state may not assert nexus, absent physical presence, against a corporation that receives income from the use of trademarks or other intangibles employed in a New Jersey business conducted by an affiliated corporation. The particular technique of tax avoidance can, however, be addressed by other measures. Certain jurisdictions require combined reporting by all corporate components of an enterprise engaged in a unitary business conducted in part within the taxing state. Combined reporting would, as Professor Pomp noted, return to taxable income the royalty payment received by the holding company. Other jurisdictions have elected to disallow the deduction by the operating company. New Jersey is not a combined reporting jurisdiction, but a recent amendment to the CBT disallows deductions for royalty payments made to a related entity for use of intangible property, as those terms are defined in the statute. *N.J.S.A.* 54:10A-4.4. (enacted as *L.* 2002, *c.* 40, *sec.* 33, effective July 2, 2002). This opinion, of course, does not address the interpretation of the amendment in any particular factual situation. In circumstances when the

amendment does apply, however, jurisdiction to tax the company receiving royalty income from use of its intangibles in New Jersey is not essential to capture that income in this state's tax base.

In conclusion, since it has been determined that physical presence is a necessary element of Commerce Clause nexus for taxation, judgment shall be entered in favor of plaintiff Lanco invalidating the Director's determination that it is subject to the New Jersey Corporation Business Tax.

APPENDIX D

REVISED STATUTES OF NEW JERSEY, 1937 (As Amended to Date), TITLE 54 – TAXATION, SUBTITLE 4 – PARTICULAR TAXES ON CORPORATIONS AND OTHERS, PART 1. –PROVISIONS APPLICABLE TO CORPORATIONS GENERALLY, Ch. 10A. Corporation Business Tax Act (1945) (As added by Ch. 162, Laws 1945, effective January 1, 1946, as amended to date.).

Sec. 54:10A-2. Franchise tax; annual payment in lieu of taxes upon intangible personal property; "doing business, employing or owning capital or property in state" defined. –

Every domestic or foreign corporation which is not hereinafter exempted shall pay an annual franchise tax for the year one thousand nine hundred and forty-six and each year thereafter, as hereinafter provided, for the privilege of having or exercising its corporate franchise in this State, or for the privilege of doing business, employing or owning capital or property, or maintaining an office, in this State. And such franchise tax shall be in lieu of all other State, county or local taxation upon or measured by intangible personal property used in business by corporations liable to taxation under this act [chapter] but, whenever such corporation holds shares of stock in a bank as defined in R. S. 54:9-1, and such bank has not elected to have the taxable value of such shares assessed to it and to pay the tax levied against such shares as provided in R. S. 54:9-14, or, having made such election, such bank subsequently revokes it, the provisions of this section shall not exempt such shares of stock from the tax imposed by chapter 9 of Title 54 of the Revised Statutes.

(As amended by Ch. 95, Laws 1973, effective April 25, 1973.)

A foreign corporation shall not be deemed to be doing business, employing or owning capital or property in the State, for the purposes of this act [chapter], by reason of (1) the maintenance of cash balances with banks or trust companies in this State, or (2) the ownership of shares of stock or securities in this State if such shares or securities are pledged as collateral security, or deposited with one or more banks or trust companies or brokers who are members of a recognized security exchange, in safekeeping or custody accounts, or (3) the taking of any action by any such bank or trust company or broker, which is incidental to the rendering of safekeeping or custodian service to such corporation.

(Sec. 54:10A-2 above is as amended by Ch. 95, Laws 1973, effective April 25, 1973.)

New Jersey Regulation, Reg. 18:7-1.6. **Subjectivity To Tax – How Created. –**

(a) Every corporation not expressly exempted is deemed to be subject to tax under the Act and is required to file a return and pay a tax thereunder provided it falls within any one of the following:

1. Existing under the laws of the State of New Jersey; or

2. If a foreign corporation,

i. Holding a general certificate of Authority to do business in this State issued by the Secretary of State; or

ii. Holding a certificate, license or other authorization issued by any other State department or agency, authorizing the company to engage in corporate activity within this State; or

iii. Doing business in this State; or

iv. Employing or owning capital in this State; or

v. Employing or owning property in this State; or

vi. Maintaining an office in this State.

(Amended November 4, 1996.)

New Jersey Regulation, Reg. 18:7-1.9. **Doing Business in New Jersey; Definition and Rules of Construction. –**

(a) The term "doing business" is used in a comprehensive sense and includes all activities which occupy the time or labor of men for profit.

1. Regardless of the nature of its activities, every corporation organized for profit and carrying out any of the purposes of its organization within the State shall be deemed to be "doing business" for the purposes of this Act.

2. In determining whether a corporation is "doing business," it is immaterial whether its activities result in a profit or a loss.

(b) Whether a foreign corporation is doing business in New Jersey is determined by the facts in each case. Consideration is given to such factors as:

1. The nature and extent of the activities of the corporation in New Jersey;

2. The location of its offices and other places of business;

3. The continuity, frequency and regularity of the activities of the corporation in New Jersey;

4. The employment in New Jersey of agents, officers and employees;

5. The location of the actual seat of management or control of the corporation.

Example

Foreign corporation R holds trademarks that were assigned to it by its parent corporation. R receives fees as a result of licensing those trademarks to certain New Jersey companies for use in New Jersey. R is subject to the corporation business tax on its apportioned income as a result of its trademark licensing activities.

(c) A foreign corporation shall not be deemed to be doing business or employing or owning capital or property in this State for the purposes of the Act by reason of the following:

1. The maintenance of cash balances with banks or trust companies in New Jersey;

2. The ownership of shares of stock or securities kept in New Jersey in a safe deposit box, safe, vault or other receptacle rented for the purpose, or pledged as collateral security, or deposited with one or more banks or trust companies, or brokers who are members of a recognized security exchange, in safekeeping or custody accounts;

3. The taking of any action by any such bank or trust company or broker which is incidental to the rendering of safekeeping or custodian service to such corporation.

4. Any combination of the foregoing activities.

(d) If the only business activity of a foreign corporation within New Jersey consists of the solicitation of orders for sales of its tangible personal property, which orders are to be sent outside the State for acceptance or rejection and, if accepted, are to be filled by shipment or delivery from a point outside the State, then such corporation is doing business in New Jersey and is subject to the tax. Unless it has additional contacts with New Jersey, however, it will not be liable for any tax measured by the income of the corporation. (See P.L. 86-272, U.S.C. §381). The corporation will be liable for filing a return and payment of the minimum tax.

1. For the in-State activities of the foreign corporation to immunize the corporation from taxation measured by income, such activities must be limited solely to:

i. Speech or conduct that explicitly or implicitly invites an order; and

ii. Activities that neither explicitly nor implicitly invite an order but that are entirely ancillary to requests for an order.

2. Examples of additional activities or contact with New Jersey that will subject a corporation to the tax based on or measured by income are:

i. Repairs, maintenance, and installations;

ii. Collection or repossession activities;

iii. Credit investigations;

iv. Personnel courses or lectures;

v. Technical assistance;

vi. Customer complaint resolution if the sole purpose is not to ingratiate sales personnel with the customer;

vii. Approving or accepting orders or securing deposits on sales;

viii. Acquiring personnel for other than solicitation activities;

ix. Maintaining a display at a single location in excess of two weeks during the tax year;

x. Carrying samples for sale, exchange or distribution in any manner for consideration or other value;

xi. Owning, leasing, or maintaining instate facilities such as a warehouse or answering service; and

xii. Consignment of personal property.

3. Examples of additional activities which, together with the solicitation activities described in (d)1 above will not subject corporation to tax based on or measured by income are:

i. Solicitation of orders through advertising;

ii. Carrying samples for display or distribution without charge;

iii. Providing automobiles, owned or leased, registered or not registered in New Jersey to sales personnel for their use in conducting protected activities;

iv. Checking customer inventories without charge;

v. Maintaining a display at a single location for less than two weeks during the tax year;

vi. Recruitment, training, or evaluating of sales personnel;

vii. A sales employee's in-home work space that is not paid for by the company; and

viii. Mediating customer complaints if just to ingratiate sales personnel with the customer.

(e) Independent contractors may solicit or make sales or maintain an office without subjecting a company to liability for tax based on or measured by income. Sales representatives who represent a single principal would not be considered independent contractors. A corporation would be subject to income based tax if the independent contractor maintained a stock of goods in the State under consignment or for purposes other than for display and solicitation.

Example

Foreign corporation L, represented in New Jersey by a foreign independent contractor, licensing software to New Jersey businesses. L receives fees from New Jersey companies for licensing the software. L is subject to the corporation business tax on its apportioned income.

(Amended April 18, 1994, April 3, 1995; November 4, 1996.)

APPENDIX E

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TAX COURT OF NEW JERSEY
DOCKET NO. 005329-1997

LANCO, INC.,	Civil Action
Plaintiff,	JOINT STIPULATION OF FACTS
v.	
DIRECTOR, DIVISION OF TAXATION,	[Exhibits to the Joint Stipulation of Facts are Intentionally Omitted]
Defendant.	

The parties hereby stipulate to the following facts for the purposes of the issues pending in the above-entitled matter only. Entry into this Joint Stipulation of Facts does not constitute a waiver of any objections as to the relevancy of the stipulated facts contained therein.

1. The issue in this case is whether Lanco, Inc. ("Lanco") is subject to tax under the Corporation Business Tax ("CBT") Act and is required to file CBT returns for the period February 11, 1983 through the present ("the period in issue"). Unless otherwise specified, all statements below refer to the period in issue.

2. Attached hereto as Exhibit A is a copy of the Complaint that was timely filed by Lanco. Attached to the Complaint is a copy of the determination issued by the Division of Taxation ("Division") to Lanco dated June 26, 1997, asserting that Lanco is required to file CBT returns for the period in issue (the "Subjectivity Notice"). Also attached to the Complaint is a copy of the New Jersey Schedule N (Nexus-Immune Activities Declaration) which was submitted by Lanco to the Division.

3. Attached hereto as Exhibit B is a copy of the Answer that was filed by the Director, Division of Taxation ("Director").

4. Lanco was incorporated in Delaware on December 15, 1982.

5. Lanco was formed to own, protect and license various trademarks, trade names and service marks (together, the "marks").

6. Lanco has registered all of its marks with the United States Patent and Trademark Office. Attached hereto as Exhibit C is an example of such a registration for one of the marks.

7. Lanco also registered its marks in numerous countries outside of the United States of America. Attached hereto as Exhibit D is a schedule of the dates that applications for some of such registrations were filed in other countries, copies of the registrations, and print-outs of the records maintained concerning the registrations.

8. No registration of any of the marks was ever obtained in the State of New Jersey by Lanco.

9. Lane Bryant, Inc. ("Lane Bryant") was incorporated in Delaware on April 26, 1982.

10. Lane Bryant is engaged in the nationwide retail sale of women's clothing and accessories.

11. Lanco and Lane Bryant are related by common ownership. Both Lanco and Lane Bryant are indirect subsidiaries of The Limited, Inc.

12. Pursuant to written agreement, Lanco licenses the use of its marks to Lane Bryant. Attached hereto as Exhibit E is a copy of the license agreement that is currently in effect.

13. Lanco receives royalty payments from Lane Bryant. The royalties are at arm's length rates.

14. Lane Bryant utilizes the marks in its business throughout the United States, including in New Jersey.

15. Lanco conducts all of its licensing activities from outside of New Jersey.

16. Lanco maintains no bank account, certificate of deposit or other financial accounts or safe deposit boxes at a banking institution within the State of New Jersey.

17. Lanco holds no interests in real property located in the State of New Jersey.

18. Lanco does not own any interest in tangible personal property located in the State of New Jersey.

19. Lanco has never maintained an office in the State of New Jersey. Originally, from 1983 through 1988, its offices were at 2625 Concord Pike, Wilmington, Delaware. Beginning January 9, 1989, Lanco's office was located at 1404 Foulk Road, Foulkstone Plaza, Wilmington, Delaware. From 1990 through the present, Lanco has had its office at

1105 North Market Street, Suite 902, Wilmington, Delaware 19899-8985.

20. Lanco has no officers or employees performing work for it in the State of New Jersey.

21. Lanco's Board of Directors has never held any meetings in the State of New Jersey. Lanco's shareholders have never held any meetings in the State of New Jersey.

22. Lanco has no agents in the State of New Jersey.

23. Lanco has never organized or sponsored any meetings in the State of New Jersey.

24. Lanco has purchased no goods or services from a contractor, subcontractor or vendor located in the State of New Jersey.

25. All of Lanco's activities concerning the protection of its marks occur outside New Jersey.

26. Attached as Exhibit F is Plaintiff 's Response to Defendant's First Supplemental Interrogatories.

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No. 06-1236

In the
Supreme Court of the United States

LANCO, INC.,

Petitioner,

v.

DIRECTOR, DIVISION OF TAXATION,

Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of New Jersey

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

ARGUMENT

I. CERTIORARI IS NOT WARRANTED BECAUSE THE STATES ARE IN ACCORD ON THE QUESTION OF WHETHER THE COMMERCE CLAUSE PERMITS THE ASSESSMENT OF INCOME TAX ON REVENUE GENERATED BY A CORPORATE TAXPAYER FROM THE USE OF INTANGIBLE PROPERTY IN THE STATE, BUT TRANSFERRED THROUGH A TAX AVOIDANCE MECHANISM TO A RELATED COMPANY IN A STATE THAT SHELTERS THAT INCOME FROM TAXATION.

Petitioner seeks to draw this Court into a field where judicial precedent has firmly developed in a uniform fashion and where State legislative action has largely eliminated the continuing validity of the tax avoidance mechanism -- the intangible property holding company (IHC) – that is the subject of this appeal. Intervention by this Court is not warranted because the *per curiam* decision below is in accord with the decisions of other State courts that have addressed the issue and conforms with legislative developments in a vast majority of States, including New Jersey, that eliminate the ability of related entities to escape taxation through the use of an IHC.

An IHC is a corporate entity created by a parent or operating company to hold intangible assets, usually the trademarks, service marks, and good will of a related company. IHCs are physically located in a State, Nevada and Delaware are two popular examples, that does not impose income tax on revenue generated by intangible property. The IHC has no employees, property or bank accounts outside of the tax-haven State. The parent company transfers the intangible assets to the IHC, which enters into an agreement with the parent to permit

the use of the intangible property for retail or other purposes by the parent company or its related entities in various States. The parent or related company agrees to pay a royalty to the IHC, generally based on a percentage of the gross income earned by the related company through the use of the intangible assets, and deducts that royalty from the parent or related company's State income as a business expense. The IHC pays no tax on the royalty payments to its home tax-haven State, and resists attempts at taxation by the State in which the IHC's intangible property is used to generate revenue by arguing that the Commerce Clause precludes taxation because the IHC has no physical presence in the taxing State.

This scenario is precisely what transpired here. The parent company of Lane Bryant, a retailer of women's clothing, formed Lanco, a Delaware IHC. 52a. The parent transferred to Lanco the trademarks, service marks and good will associated with Lane Bryant stores, some of which are located in New Jersey. 53a. Lane Bryant and Lanco entered into an agreement through which Lane Bryant pays a monthly royalty in the form of a percentage of Lane Bryant's gross sales in New Jersey in exchange for the use of Lanco's intangible property. *Id.* Lane Bryant deducts the payments from its New Jersey income as a business expense, thereby significantly reducing its tax obligation to the State. Lanco pays no tax on the royalties to Delaware and takes the position that it may not be taxed by New Jersey because it has no physical presence in the State.

Although Lanco seeks to pay no tax to New Jersey on the income that it earns from the exploitation of the State's marketplace, Lanco derives numerous benefits from the use of its property in New Jersey. As the Tax Court of New Jersey found after hearing expert testimony, "Lanco clearly enjoys the same benefits provided to Lane Bryant" by New Jersey. 36a. In addition, among the expert testimony heard by the trial court was that "Lanco's licensure of intangibles for use in New Jersey imposes costs on the state because it generates economic activity that increases the demand for public services . . . ." 36a-37a. The expert opined that "Lanco benefits from this

activity, since it receives fees that increase with sales." 37a. Because Delaware does not tax income earned from the use of Lanco's intangibles, if petitioner prevails in its erroneous view of the Commerce Clause and escapes taxation by New Jersey, Lanco will pay no State income tax on its considerable earnings and a significant percentage of the income generated by retail sales in New Jersey will have been shielded from taxation by any State.

A. State Courts Are In Agreement In Holding That States May Impose Income Tax On Revenue Generated Through The Use of Intangible Property Where Taxpayers Attempt To Export That Revenue To A Tax-Haven State.

The Commerce Clause authorizes Congress to "regulate Commerce . . . among the several States . . . ." U.S. Const. art. 1, § 8, cl. 3. The dormant Commerce Clause is a "judicial creation" that presumes that the Clause "not only empowers Congress to regulate interstate commerce, but also imposes limitations on the States in the absence of congressional action . . . ." *C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383, 401 (1994)(O'Connor, J., concurring). The essence of the Clause is that one State, in its dealings with other States, may "not place itself in a position of economic isolation . . . ." *City of Philadelphia v. New Jersey*, 437 U.S. 617, 623 (1978) (quotations omitted). Nor may a State enforce economic protectionism by penalizing interstate commerce for the benefit of similar intrastate economic activity. *Fulton Corp. v. Faulkner*, 516 U.S. 325, 330 (1996).

It has long been settled that in the area of State taxation a tax on interstate economic activity does not offend the Commerce Clause if it "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). It is the substantial nexus prong, and the question of whether an IHC

must be physically present in a State where its trademarks or other intangible property generate profits through retail sales by an affiliated or related corporation to satisfy the *Complete Auto Transit* test, that is presented by this petition.

The Supreme Court below, in deciding that question, reached the same result as every other court that has issued a published opinion on the subject: the physical presence test set forth by this Court in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), for establishing substantial nexus in the context of requiring a mail-order catalogue vendor to collect and remit sales and use tax does not apply outside of that limited area. This test, affirmed on the basis of *stare decisis* in *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992), has consistently been found not to apply to IHCs that attempt to shield from State taxation revenues generated by the use of their intangible property by related entities with a physical presence in the taxing State. Contrary to the arguments posited by petitioner, the State court decisions in this area are uniform and do not require clarification by this Court.

Shortly after issuance of the *Quill* decision, the South Carolina Supreme Court recognized the limited scope of the physical presence requirement applicable in the sales and use tax collection context. *Geoffrey, Inc. v. So. Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C.), *cert. denied*, 510 U.S. 992 (1993). There, the South Carolina Court upheld the application of that State's corporate income tax in circumstances strikingly similar to those before the New Jersey court below. Geoffrey was a Delaware holding corporation with no employees, officers, or tangible property in South Carolina. *Id.* at 15. The company owned several valuable trademarks and trade names, including "Toys 'R' Us," a trademark that matched the name of its parent corporation. *Id.* Through a licensing agreement with its related company, Geoffrey permitted the use of its trademarks by Toys "R" Us in South Carolina. Geoffrey received as consideration a percentage of the parent's net sales of merchandise in that State. *Id.* As is the case with Lanco, the effect of the corporate relationship between Geoffrey, Toys "R"

Us and their licensing agreement was the creation of "nowhere" income that escaped State taxation entirely. *Id.* at 15 n.1. In fact, in 1990, Geoffrey, without any full-time employees, had income of approximately $55 million and paid no State income tax at all. *Id.*

South Carolina ultimately made a determination that Geoffrey was subject to that State's corporate income tax. *Id.* at 15. Geoffrey claimed that the Commerce Clause allowed it to shield all of the profits that it made in South Carolina from State taxation because the company did not have a physical presence in that State. *Id.* at 16. Thus, the taxpayer in *Geoffrey* raised the identical argument Lanco makes in the case before this Court in an attempt to escape paying its fair share of tax to New Jersey.

The South Carolina Court, like the court below, found that the Commerce Clause was not offended by application of South Carolina's tax to the IHC. The Court found that reliance on the *Bellas Hess* physical-presence test by the taxpayer was "misplaced." *Id.* at 18. The court began its analysis by remarking that this Court in *Quill*, while reaffirming *Bellas Hess* for sales and use tax purposes, "noted that the physical presence requirement had not been extended to other types of taxes." *Id.* at 18 n.4. Recognizing legal precedents that permit the imposition of taxes other than sales and use tax in the absence of physical presence, the Court held "that by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a 'substantial nexus' with South Carolina" for Commerce Clause purposes. *Id.* at 18.

Similarly, in *A & F Trademarks, Inc. v. Tolson*, 605 S.E. 2d 187 (N.C. Ct. App. 2004), *certif. denied*, 611 S.E.2d 168 (N.C.), *cert. denied*, 126 S. Ct. 353 (2005), the North Carolina Court of Appeals upheld the imposition of corporate taxes against corporations, including Lanco, the petitioner here, that had no physical presence in that State, but which licensed the use of their trademarks to North Carolina retailers. That court properly rejected the notion that *Quill* created an immutable

bright-line rule requiring physical presence before any corporate tax can be assessed against an entity conducting business in a State. *Id.* at 194. The *A & F* court adopted the themes that underlie the consistent line of precedent permitting the taxation of IHCs: (1) that significant differences exist between the sales and use taxes examined in *Quill* and the corporate business taxes assessed against IHCs, (2) that IHCs could not reasonably rely on a supposed bright-line rule requiring physical presence for the assessment of corporate taxes, and (3) that this Court begrudgingly affirmed the physical presence rule for sales and use taxes in *Quill* because of the powerful doctrine of *stare decisis*, but carefully limited its holding to the tax at issue in that case. *Id.* at 194-96. *See also Secretary, Dep't of Revenue v. Gap (Apparel), Inc.*, 886 So. 2d 459, 461-62 (La. Ct. App. 2004) (holding, without discussion of *Quill*, that Louisiana could impose a corporate income tax on a trademark holding company under facts almost identical to those presented here).

The intermediate appellate decision below, adopted by a *per curiam* decision of the Supreme Court of New Jersey, follows that rationale and the holdings in *Geoffrey* and *A & F*. *See* 20a ("We are satisfied that the physical presence requirement applicable to use and sales taxes is not applicable to income tax and the New Jersey Business Corporation Tax may be constitutionally applied to income derived by plaintiff from licensing fees attributable to New Jersey"). No published judicial opinion takes the opposite view. Under each existing precedent examining an IHC and its receipt of royalties from an affiliated corporation for use of the intangible assets, the facts of this case would have resulted in the same outcome: a holding that the Commerce Clause permits State taxation in these circumstances without the need to establish that the IHC had a physical presence in the taxing State. Simply put, there is no divergence of authority on the subject of this petition and no conflict for this Court to resolve.

State court decisions in other tax-related contexts have rejected the notion that the Commerce Clause requires a

physical presence for the imposition of an income tax. The Supreme Court of Appeals of West Virginia in *Tax Comm'r v. MBNA Am. Bank*, 640 S.E.2d 226 (W. Va. 2006), *petition for certiorari filed*, when examining a factual complex distinct from that presented by the IHC paradigm, held that the *Complete Auto Transit* substantial nexus prong does not require physical presence for the State to collect an income tax from a bank that earns money in West Virginia through its extension of credit to West Virginia consumers. This opinion, which rejected the argument that *Quill's* physical presence test applies beyond sales and use tax collection obligations, is consistent with the decision below and with each State court decision addressing State taxation of IHCs.[1]

In addition, courts have recognized that the Commerce Clause does not require a taxpayer's physical presence in a variety of other contexts. *See Borden Chemicals and Plastics, L.P. v.* Zehnder, 726 N.E.2d 73, 80 (Ill. App. Ct.)(holding application of personal property tax replacement income tax to an out-of-state corporation to be permissible because the "Quill court merely carved out a narrow exception in the area of use tax collection duties"), *app. denied*, 731 N.E.2d 762 (Ill. 2000); *Couchot v. State Lottery Comm'n*, 659 S.E.2d 1225, 1230 (Ohio)(holding that non-resident with no physical presence in State is subject to income tax on Ohio lottery winnings), *cert. denied*, 519 U.S. 810 (1996).

To support its suggestion of a conflict among the State courts, petitioner relies primarily on the holding of an

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[1]Petitioner pleads with this Court to hold this petition, should *certiorari* be granted in *MBNA*. Petition for Certiorari at 30. There is simply no reason for the Court take this approach. The unique circumstances presented by the IHCs and the overwhelming response of the States to eliminate the IHCs tax- avoidance scheme set this case apart from *MBNA*. Review is not warranted in this petition whether or not *certiorari* is granted in *MBNA*.

intermediate appellate court faced with facts significantly different from the IHC scenario. *J.C. Penney Nat'l Bank v. Johnson,* 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000). This decision reflects a wooden application of the *Quill* physical presence test with no meaningful analysis. *Id.* at 839 ("Any constitutional distinctions between the franchise and excise taxes presented here and the use taxes contemplated in *Bellas Hess* and *Quill* are not within the purview of this court to discern"). One decision of an intermediate appellate court, contrary to all other published opinions on the topic, does not constitute a conflict. Moreover, the continued validity of the *J.C. Penney* opinion has been called into doubt by subsequent judicial developments. *See e.g., America Online, Inc. v. Johnson,* 2002 WL 1751434 (Tenn. Ct. App. 2002)(rejecting a reading of *J.C. Penney* that "would simply substitute 'physical presence' for 'nexus.'"). Standing alone and undercut by subsequent precedent, the *J.C. Penney* holding is an insufficient basis for review by this Court.

Two other cases relied upon by petitioner, *Guardian Indus. Corp. v. Dep't of Treasury*, 499 N.W.2d 349 (Mich. App. 1993), *app. denied sub nom*, 512 N.W.2d 846 (Mich. 1994), and *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000), also do not create a conflict. Neither of these intermediate appellate opinions applies the Commerce Clause to the IHC factual paradigm addressed below. *Rylander* rejected an attempt by Texas to tax an out-of-State corporation merely because it possessed a license to do business in that State. *Id.* at 299. The court held that possession of a license to do business, without further economic activity, did not satisfy the substantial nexus requirement of *Complete Auto Transit.* Given the exceedingly narrow basis upon which Texas attempted to impose its tax, the *Rylander* opinion creates no conflict with the decision below or the many precedents of this Court with which it is in accord. In *Guardian Corp.*, the court was faced with an unusual question – whether "sales" in other States were subject to tax in the other States and, therefore, eligible for exclusion from Michigan income. Although the

Guardian Corp. court held that *Quill* established a physical presence requirement for the imposition of all State taxes, the peculiar fact pattern before the *Guardian Corp.* court renders its decision of limited precedential value, and far afield from presenting a conflict with the decision below.

B. State Legislatures, In The Absence Of Congressional Action, Have Largely Eliminated The Tax Avoidance Potential Of Intangible Holding Companies Through Legislation, Greatly Reducing the Significance Of The Issue Addressed By The Lower Court And Militating Against Review By This Court.

As States have come to recognize the tax avoidance artifice of IHCs, legislative action has largely eliminated this tax shelter for income from intangible licensing agreements between related companies. These statutory developments reduce the significance of the issue raised by petitioner, provide further consistency in the treatment of taxpayers and militate against review by this Court.

When applying *stare decisis* in *Quill* to continue the physical presence requirement in the context of the sales and use tax collection obligation for out-of-State entities, this Court noted that the contours of Commerce Clause limitations on State taxation was an area ripe for legislative action. "Our decision is made easier by the fact that the underlying issue is not only one that Congress may be qualified to resolve, but also one that Congress has the ultimate power to resolve." 504 U.S. at 318. Congress has not acted, leaving the States to address the issue through legislative action.

In fact, the States' legislative activity has been consistent and widespread. In response to the decision of the trial court in this matter, New Jersey enacted legislation disallowing a deduction in Corporation Business Tax for royalty payments made to a related company for the use of intangibles. N.J. Stat. Ann. §54:10A-4.4(b); N.J. Admin. Code §18:7-5.18. Fourteen

other States have acted to preclude the tax sheltering benefit intended to be gained by the creation of IHCs. *See* Ala. Code §40-18-24, 40-18-35 (disallowing deductions for payments for use of intangibles to related entities); Ark. Code Ann. §26-51-423(g)(1)(limiting circumstances in which deduction is available for payments to related companies for the use of intangible property); Conn. Gen. Stat. §12-218c(b)(requiring add-back for payments made to related company for use of intangible property); D.C. Code Ann. §47-1803.03(a)(19) (disallowing deductions for payments associated with the use of intangibles of related companies); Ga. Code Ann. §48-7-28.3(b) (requiring add-back of royalty payments to related companies for the use of intangible property); Ind. Code §6-3-2-20(b)(requiring add-back of expenses associated with intangible property of related company); Ky. Rev. Stat. Ann. §141.205(2) and (4)(disallowing deduction for expenses paid to related company for use of intangible property); Md. Code Ann. Tax-Gen. §10-306.1(b)(2)(requiring add-back of payments to related companies for use of intangible property); Mass. Gen. Laws ch. 63, §31I (a) and (b)(requiring add-back of expenses to related companies associated with intangible property); Mississippi, Miss. Code Ann. §27-7-17(2)(b) (providing for add-back of expenses associated with intangibles from a related entity); N.Y. Tax Law §208(9)(o) (requiring add-back to income of royalty payments to a related company for the use of intangible property); N.C. Gen. Stat. §105-130.7A (where recipient and "payer" of expenses associated with intangible property are related, expenses must be added back to the income of "payer" or included in the income of recipient); Ohio Rev. Code Ann. §5733.042(C)(requiring add-back to income of expenses paid to related company for use of intangible property). *See also* Va. Code Ann. §58.1-446 (allowing for adjustments to reported income for improper exclusions) and *Ruling of Comm'r*, P.D. 05-29, Va. Dep't of Taxation (Mar. 2, 2005) and *Ruling of Comm'r*, P.D. 05-28, Va. Dep't of Taxation (Mar. 7, 2005)(exercising equitable authority of Commissioner to disallow deduction of expenses paid to related company for use of intangible property). In

these States, tax avoidance through the use of IHCs has been eliminated.

An additional twenty States use combined reporting for related corporate entities, eliminating the State tax avoidance benefits of IHCs because the deduction for royalty payments to IHCs will effectively be canceled by the concomitant income to the related entity. The States with combined reporting are: Alaska, Alaska Stat. §43.20.073(a); Arizona, Ariz. Rev. Stat. Ann. §43-947; California, Cal. Rev. & Tax. Code §23362; Colorado, Colo. Rev. Stat. §39-22-303(11); Hawaii, Haw. Rev. Stat. §18-235-22-03; Idaho, Idaho Code §63-3027(t); Illinois, 35 Ill. Comp. Stat. §5/502e; Kansas, Kan. Stat. Ann. §79-32,142(a); Maine, Me. Rev. Stat. Ann. §5220 and §5200.4; Minnesota, Minn. Stat. §289A.08.3; Montana, Mont. Code Ann. §15-31-141(1) and (2); Nebraska, Neb. Rev. Stat. §77-2734.01 and .05; New Hampshire, N.H. Rev. Stat. Ann. §77-A:6; North Dakota, N.D. Cent. Code §57-38-14; Oregon, Or. Rev. Stat. §317.710(2); Texas, Tex. Tax Code §171.1014 (eff. 1/1/08); Utah, Utah Code Ann. §59-7-402; Vermont, Vt. Stat. Ann §5862; West Virginia, W. Va. Code §11-24-13a(a). New York enacted combined reporting legislation on April 1, 2007, to begin with the 2007-2008 fiscal year. Michael Mazerov, Center on Budget and Policy Priorities, *Growing Number of States Considering a Key Corporate Tax Reform* (Apr. 5, 2007). Seven additional States (Iowa, Maryland, Massachusetts, Michigan, New Mexico, North Carolina, and Pennsylvania) are considering enacting combined reporting. Institute on Taxation and Economic Policy, *Combined Reporting: How Does Your State Stack Up?* (Apr. 2007).

As demonstrated above, a majority of State legislatures and taxing authorities, including in New Jersey where this appeal initiated, have sharply curtailed the value of IHCs as State tax avoidance mechanisms. Legislatures are engaged in addressing the issue raised in the petition, and the response has been an unwavering march toward State taxation of royalties paid between related companies for the use of intangible assets. This Court should refrain from entering a field that the other

branches of government are manifestly resolving in a uniform fashion.

II. The Decision Below Does Not Leave Matters In An Unprincipled Or Confused State Because The New Jersey Supreme Court's Decision Is Consistent With, And Reflective Of, The Commerce Clause Jurisprudence Of This Court.

In requesting *certiorari* review, petitioner clamors for a "default rule," suggesting that no bright line now exists with respect to the limits on State taxation under the Commerce Clause to guide lower courts or taxpayers in *Lanco*'s wake. The proverbial "parade of horribles" raised by petitioner does not exist, however, because as noted above, the *per curiam* decision by New Jersey's Supreme Court respects, in full, this Court's Commerce Clause jurisprudence and is wholly consistent with other States' highest courts.

Moreover, the decision below comports with this Court's Commerce Clause precedents on the larger question of the meaning of the substantial nexus prong of *Complete Auto Transit*. Petitioner's claim of uncertainty rests on the incorrect notion that this Court's prior rulings established a "bright line" requiring physical presence in the context of all State taxes, including corporate franchise or income taxes. The underpinning of petitioner's argument is flawed, however, because it reflects an overly narrow reading of *Quill*, *Bellas Hess* and the other cases upon which petitioner relies, as well as petitioner's failure to recognize crucial differences between the sales and use tax collection obligation at issue in those cases and the corporate income tax under scrutiny here.

A. This Court's Precedents Have Not Required A Single, Wooden Application Of The Commerce Clause To All Types Of State Taxes.

In *Quill*, this Court noted that the relevant nexus analysis is "informed not so much by concerns about fairness for the

individual defendant as by structural concerns about the effects of state regulation on the national economy." 504 U.S. at 312. Thus, the standard for application of the Commerce Clause to State taxes is a flexible one: State tax laws may not unduly burden interstate commerce. *Kassel v. Consol. Freightways Corp.*, 450 U.S. 662 (1981); *City of Philadelphia, supra.* Indeed, the test as articulated by *Complete Auto Transit* requires a four-prong balancing which does not demand physical presence in all contexts, especially in light of the recent social, economic, commercial and legal innovations in interstate commerce.

The flexibility inherent in this Court's Commerce Clause analysis is reflected in the express delineation in *Quill* of the limited scope of the physical presence requirement: "we have not, in our review of other types of taxes, articulated the same physical presence requirement" as is required for the sales and use tax collection obligation. 504 U.S. at 314. The foregoing statement was not mere *dictum*, as petitioner suggests, but an express recognition by this Court that there exist distinctions among State taxes as well as the concomitant Commerce Clause nexus requirements for those impositions. *Id.* at 317.

In *Quill*, this Court recognized the insignificance of an entity's physical presence in a taxing State for Due Process purposes. In that context, the Court "abandoned more formalistic tests that focused on a defendant's 'presence' within a State in favor of a more flexible inquiry . . . ." *Quill*, 504 U.S. at 307. As this Court explained, "[i]n 'modern commercial life' it matters little that . . . solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: The requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State." *Id.* at 308.

The rationale for abandoning a physical presence requirement for Due Process Clause purposes recognizes that businesses engage in significant levels of commercial activity in a State without ever "setting foot" there. In this era of

"virtual offices," cellphones, BlackBerry devices and the Internet, rational enterprises can easily foresee being subject to State laws, including tax laws, as a result of their commercial activity directed to a particular State whether or not physically present in that State. Lest there be any confusion on this point, however, respondent does *not* suggest that the Due Process and Commerce Clause tests are identical, but in light of their similarities, given *Quill's* self-limiting application and *Complete Auto Transit's* four-part Commerce Clause test, there is plainly no principled reason why the Commerce Clause should require a corporation's physical presence to justify State taxation, especially when a State is able to establish that the corporation derives significant benefits from continued and deliberate economic activity in the taxing State, as New Jersey did through expert testimony adopted by the trial court below. 37a.

Indeed, while recognizing that over the last half of the Twentieth Century the Court has crafted a pragmatic approach to the Commerce Clause, the powerful influence of the doctrine of *stare decisis* ultimately swayed the *Quill* Court to follow its holding in *Bellas Hess* with respect to sales and use tax collection obligations. 504 U.S. at 309-11. The Court noted, however, that "[w]hile contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, *Bellas Hess* is not inconsistent with *Complete Auto* and our recent cases." *Id.* at 311.

Having thus expressed its doubts about the continuing viability of the underlying wisdom of *Bellas Hess* as long as 15 years ago, the Court nonetheless declared that it would not abandon "the rule that *Bellas Hess* established *in the area of sales and use taxes.*" *Id.* at 317 (emphasis added). As New York's highest court describes the result: "the *Quill* decision cannot be substantively construed as other than a somewhat begrudging retention of the *Bellas Hess* physical presence requirement" for imposition of a sales tax collection obligation. *Orvis Co., Inc., v. Tax Appeals Tribunal*, 654 N.E.2d 954, 960 (N.Y.), *cert. denied sub nom*, 516 U.S. 989 (1995).

The decisive role of *stare decisis* in the continuation of the *Bellas Hess* standard in *Quill* cannot be overstated. The influence that the doctrine had on the holding in *Quill* is starkly revealed in the concurring opinion of Justices Scalia, Kennedy and Thomas, who would have adhered to *Bellas Hess* on grounds of *stare decisis* alone, 504 U.S. at 319-20, and in the partial dissent of Justice White, who thought that the physical presence rule was so anachronistic that he would have abandoned it in spite of *stare decisis*, *id.* at 322.

Petitioner is equally mistaken in its contention that the taxes at issue in *Quill* and in *Lanco* "are essentially indistinguishable" even in their economic effects. Petition for Certiorari at 19. Significant differences exist between the sales and use taxes found to require a physical presence for Commerce Clause purposes in *Bellas Hess* and *Quill* and the corporate franchise tax imposed in *Lanco*. The *Quill* Court expressed great concern about the then-6,000 local taxing jurisdictions throughout the United States which might impose varying rates, exemptions and reporting requirements for sales and use taxes on Quill. 504 U.S. at 313 n.6.

As this Court noted, sales and use taxes are generally due on a monthly basis. Today there exist approximately 7,500 distinct sales and use tax jurisdictions, many with different tax bases, different deductions and even different tax reporting forms. While the burden and cost of complying with such a vast array of sales and use tax requirements may still require a heightened presence requirement, petitioner is incorrect in its contention that "the complexity and burden of complying with corporate income and franchise taxes are greater than . . . [for] sales and use tax compliance." Petition for Certiorari at 20-21.

Corporate franchise taxes, like the Corporation Business Tax at issue in this case, are imposed on an annual basis. Corporate net income generally follows income computed for federal tax purposes. *See, e.g.*, N.J. Stat. Ann. 54:10A-4(d). Only forty-eight jurisdictions -- forty-six States, the District of Columbia, and the City of New York -- collect a corporate

franchise or income tax. Each such jurisdiction requires an annual return. *Congressional Research Service,* State Corporate Income Tax: A Description and Analysis (June 30, 2006) at CRS-2. Thirty-five States use the same measure of income as employed by the federal government. *Id.* at CRS-3. "The remaining states typically use a measure of income that closely follows the federal definition of taxable income. Using the federal starting point likely eases the compliance burden for corporations, particularly those that have nexus in several states." *Id.*

As one noted commentator put it:

> it may well be that the need for a "bright-line" rule in the context of income taxation is less compelling than in the context of sales and use taxation because the burdens of complying with the income tax laws of various state and local jurisdictions are less daunting than the burden of complying with the laws of the nation's 6,000-plus sales and use tax jurisdictions to which the Court alluded in *Quill.* [J. Hellerstein & W. Hellerstein, *State Taxation* Warren, Gorham & Lamont (3d ed. 1998) ¶6.30[5]].

Petitioner is thus plainly wrong when it contends that the court below, and the other State courts that reached the same result with respect to the taxation of IHCs, have unconstitutionally facilitated or created "relaxed nexus requirements" which "increase the burden on interstate commerce." Petition for Certiorari at 21. New Jersey sought only to tax income Lanco earned from New Jersey, on an apportioned basis. The realities of New Jersey - and other States' - corporate franchise or income taxes do not threaten to impose a meaningful administrative burden on the multistate corporations which reap significant economic benefits from the State markets they exploit.

B. New Jersey And Other States That Impose Income Or Franchise Taxes On IHCs Do Not Reach Beyond Their Borders And *Lanco* Follows This Court's Commerce Clause Analysis Which Is Manageable By The Judiciary And Taxpayers Alike.

Petitioner suggests that through *Lanco* and other similar cases, States have reached "outside [their] borders" to impose income or franchise taxes on IHCs. Petition for Certiorari at 23. The outer limit of petitioner's alarmist assertion is that there now exists no "judicially manageable default rule" applicable to State taxes. *Id.* at 22

Nothing could be further from the truth. First, as noted above, New Jersey's Appellate Division, in an opinion adopted by a *per curiam* decision of the Supreme Court, gave full effect to the flexible Commerce Clause nexus analysis enunciated by this Court in *Quill* and other precedents. In addition, as even petitioner concedes, the "modern economy may lack borders." *Id.* at 25. Indeed, the artifice of IHCs was created to capitalize on that very concept. And, as discussed above, the trial court in this case adopted expert testimony demonstrating that Lanco's exploitation of the New Jersey retail clothing sales market both burdened the State and benefitted Lanco in very concrete ways.

As a result, while it is true that one of the reasons that the *Quill* Court noted for abiding by *Bellas Hess* in the context of sales and use tax collection obligation was the idea that retaining the physical presence test would comport with "settled expectations and, in doing so, foster[] investment by businesses and individuals," 504 U.S. at 316, no such "settled expectations" exist with respect to other types of State taxes. This is so in part because of *Quill*'s express limitation to sales and use taxes. Moreover, the previously unfathomable technological changes of the last few decades have dictated that there are no "settled expectations" in business. The recent advent of entities such as IHCs, LLCs and other innovative

corporate formats confirms that "investment" is fostered in relation to the needs of the marketplace, not by the geopolitical boundaries of the various States.

Finally, petitioner suggests that principles of federalism provide a basis for *certiorari* in this case, asserting that "sovereignty over a specified geographical area and those who come within it" are somehow offended by Lanco. Petition for Certiorari at 26. This contention is erroneous because it suggests that New Jersey as well as any other States that tax IHCs are attempting to reach beyond their borders to tax multistate corporations. If federalism has any application to this petition at all, it supports the ability of the States to carry out their core governmental function of raising revenue through taxation. Petitioner's view of the law would undermine this important State function by imposing unnecessary limitations on State taxation.

State income and franchise taxes are judicially manageable under *Lanco* as well as the other State court decisions which have identically imposed tax on IHCs in accordance with this Court's Commerce Clause precedents. There is nothing "unprincipled" about asking corporations that reach into States for business and, presumably, profit, to pay their fair share of tax to those States on a constitutionally-approved apportioned basis.

CONCLUSION

For the foregoing reasons, the petition for a writ of *certiorari* should be denied.

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In The

Supreme Court of the United States

LANCO, INC.,

Petitioner,

v.

TAX COMMISSIONER OF THE STATE OF NEW JERSEY,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of New Jersey

BRIEF OF *AMICUS CURIAE* THE SHERWIN-WILLIAMS COMPANY IN SUPPORT OF PETITIONER

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STATEMENT OF INTEREST OF *AMICUS CURIAE*[1]

The Sherwin-Williams Company ("Sherwin-Williams") is an Ohio Corporation in the business of manufacturing and retailing paint and paint-related products. Sherwin-Williams is actively engaged in interstate commerce, doing business in all 50 states. As such, Sherwin-Williams relies on this Court's interpretation of the Commerce Clause of the United States Constitution when making business decisions and otherwise conducting itself in the interstate marketplace.

As this Court noted in *Quill Corp. v. North Dakota*, the law in the area of state tax nexus is in something of a quagmire. 504 U.S. 298, 315 (1992). This is especially true in the context of state income tax nexus. Fifteen years ago in *Quill*, this Court reaffirmed the long-standing rule that a business must be physically present before a state may impose the burden to collect its sales tax on that business. *Id.* at 317-18. Businesses relied on *Quill* and the fact that this Court has never held that a state may impose its tax on a business without physical presence. Businesses reasonably believed the physical presence rule applied to all types of state tax and made decisions consistent with this reasonable understanding. Some state courts and state departments of taxation agreed,[2] while other states

---

[1] The parties have consented to the filing of this brief.

Counsel for a party did not author this brief in whole or in part. No person or entity, other than the *Amicus Curiae*, its members, or its counsel made a monetary contribution to the preparation and submission of this brief.

[2] For instance, in 2000, the Tennessee Supreme Court affirmed a lower court decision holding the physical presence rule applies in the context of the income tax. *JC Penney Nat'l Bank v. Johnson*, Comm'r of Revenue, No. M1998-00497-SC-R11_CV (Tenn. May 8, 2000) (per

(Continued on following page)

saw an opening to increase revenue based on this Court's dicta in *Quill*.

Starting with South Carolina, many state courts, leaping a few logical steps, adopted the theory that *Quill* applies only in the context of the sales tax. *See Geoffrey, Inc. v. SC Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993); *see also, e.g., A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. 2004); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005). These states, seizing upon dicta in *Quill*, concluded they could impose their income taxes on businesses with absolutely no physical presence within their borders.[3]

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curiam). The New Jersey Tax Court, in this case, similarly held that the physical presence rule applies in the context of the income tax only to be later reversed by the state's appellate court, whose decision was later affirmed by New Jersey's highest court. *Lanco, Inc. v. Director, Div'n of Tax'n*, 21 N.J. Tax 200 (2003).

[3] For example, the West Virginia Supreme Court of Appeals recently held:

> [T]he Supreme Court appears to have expressly limited *Quill's* scope to sales and use taxes. First, the *Quill* Court noted that "[although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." *Quill*, 504 U.S. at 314, 112 S.Ct. at 1914. Also, the Court commented that "although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes." *Id.*, 504 U.S. at 317, 112 S.Ct. at 1916. We believe that a reasonable construction of this language clearly implies that *Quill* applies only to sales and use taxes and not to other types of state taxes.

(Continued on following page)

Businesses like Sherwin-Williams relied on *Quill* and its ancestors in the absence of a separate ruling from this Court on state income tax nexus. When states impose their income tax on corporations with no physical presence, the consequences are often extremely and inappropriately harsh. This climate of uncertainty and potential harshness prevents multistate businesses like Sherwin-Williams from confidently broadening the scope of their interstate activities. Therefore, not only is it in Sherwin-Williams' interest, but also the free flow of interstate commerce necessitates this Court clarify that the bright-line physical presence rule applies in the context of the state income tax.

SUMMARY OF ARGUMENT

In *Quill*, this Court held that the bright-line physical presence rule furthered the ends of the Commerce Clause, declaring "[u]ndue burdens on interstate commerce may be avoided . . . in some situations, by the demarcation of a discrete realm of commercial activity that is free from interstate taxation." 504 U.S. at 314-15. This Court further explained that a bright-line physical presence rule establishes the states' taxing authority and consequently reduces litigation related to that authority. *Id.* at 315.

This is exactly why a bright-line physical presence rule in the context of state income tax nexus is critical to a multistate businesses like Sherwin-Williams. There is no justification for a bright-line physical presence rule only in

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Tax Comm'r of State v. MBNA America Bank, N.A., 640 S.E.2d 226, 232 (W.Va. 2006).

the context of the sales or use tax. Despite what some state courts and academics claim, the reality from the perspective of multistate businesses is that the complexities and compliance demands of income tax laws require greater certainty and a clearer nexus rule than sales and use tax laws demands.

In addition, more is at stake for multistate businesses when a state directly imposes its income tax on those businesses versus when a state imposes on such businesses the mere duty to collect sales or use tax from customers for remittance to the state. The uncertainty resulting from the lack of a bright-line physical presence rule has created a harsh environment in which multistate companies are potentially subject to unjustifiably huge penalties and back income tax liabilities for periods extending back many years.

Moreover, dramatic changes in the climate of interstate commerce occurring since the *Quill* decision in 1992 have raised the stakes even higher. Since *Quill* was decided, the nation has experienced several financial accounting scandals and a dramatic rise in attention to corporate financial accountability. Along with Congressional mandates like Sarbannes-Oxley, the Financial Accounting Standards Board ("FASB") has issued rules for corporate accounting increasing the stakes associated with accounting for income taxes on corporate financial statements. FASB Statement No. 109, *Accounting for Income Taxes* and its related interpretation, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), relate to the recognition of tax benefits and liabilities on a company's financial statement. FIN 48 magnifies the ill effects of the ambiguity surrounding the Commerce Clause as it applies to state income tax nexus.

As *Quill* explains, a bright-line physical presence rule allows corporate taxpayers to precisely determine whether a state may impose a tax on them and if so, to what extent the state may tax them. This principle does not only mandate a bright-line physical presence rule in the case of state sales and use tax. Because of the complexities of income tax laws, the burdens of compliance, and the high stakes involved, a bright-line physical presence rule is absolutely critical in the case of state income tax nexus.

ARGUMENT

I. The Burdens of Compliance with and the Complexity of State Income Tax Laws Necessitate a Bright-Line Physical Presence Rule for State Income Tax Nexus.

While the New Jersey court in this case maintains that there are "'important distinctions between sales and use taxes [as compared to] income and franchise taxes that makes the physical presence test . . . inappropriate as a nexus test' for taxation beyond the use and sales taxes," in fact, the opposite is true. *See Lanco, Inc. v. Director, Div. of Tax'n*, 879 A.2d 1234, 1240 (N.J. Super. A.D., 2005) (quoting *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194) (alterations in original). Differences between the burdens of complying with sales tax laws versus the burdens of complying with income tax laws do not warrant a bright-line physical presence rule for one and not the other. If anything, the compliance burdens associated with state income tax laws, financial accounting rules, and investor reliance on companies' effective income tax rates reporting dictate that it is even more important to have a bright-line unambiguous physical presence rule in the case of the

income tax than it is to have such a rule in the context of the sales tax.

Sherwin-Williams is on the front lines of state tax law compliance, working every day and devoting an entire department of the company to compliance with both sales tax laws and income tax laws, as well as many other types of tax. Sherwin-Williams has first-hand knowledge that complying with state income tax laws is more burdensome than complying with any other type of tax law and income tax laws are far more complex than any other type of tax law, including sales and use tax laws.

Some State courts and academics have focused on the number of returns rather than the complexity of compliance with the respective state laws and generally grossly underestimate the amount of jurisdictions to which multi-state companies must file income tax returns. A typical state court justification for concluding that compliance with state income tax laws is less onerous than compliance with state sales tax laws is because "state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, [but] a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates." *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194 (N.C. App. 2004); *see also, e.g., Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 234 (W.Va. 2006); Cory D. Olson, Comment, *Following the Giraffe's Lead – Lanco, Inc. v. Director, Division of Taxation Gets Lost in the Quagmire That Is State Taxation*, 6 MINN. J. L. SCI. & TECH. 789, 813-14 (2005).

This is not the reality for multi-state businesses like Sherwin-Williams. In many states, localities are permitted to impose their own income taxes on corporations.[4] Additionally, many income-taxing jurisdictions require multiple income tax filings each year, as well as estimated periodic.[5] Also, when a corporate taxpayer needs more time to file a return it generally must file an application for an extension. Sherwin-Williams files returns in approximately 170 state and local income tax jurisdictions on behalf of itself and its subsidiaries. As such, over the course of a typical year, the Sherwin-Williams' Tax Department files approximately 1700 income tax returns, estimated periodic payments, or applications for extensions to file returns.

Another typical argument that compliance with state sales tax laws is more onerous than compliance with state income tax laws is that the differences are less complex between state and local income tax laws across jurisdictions than the differences in sales tax laws across jurisdictions. *See, e.g.,* John A. Swain, *State Income Tax Jurisdiction: A Jurisdictional and Policy Perspective*, 45 WM. & MARY L. REV. 319, 368 (2003) (arguing "several key features of state corporate income taxes suggest that they are significantly less burdensome" to comply with than state sales tax laws). From Sherwin-Williams' perspective, this is simply not true.

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[4] Sherwin-Williams' home city of Cleveland, Ohio, for example, imposes an income tax on the company as do over 50 municipalities in the Greater Cleveland area alone. CLEVE. CITY INCOME TAX ORD. § 191.0101 (2004).

[5] Alabama and Idaho are just two of many examples of income-taxing jurisdictions requiring quarterly filing. ALA. ADMIN. CODE 810-3-82-.02 (2006); IDAHO CODE § 63-3036A (2001).

The difference between state sales tax laws generally is limited to exemptions, rates, and the timing and manner of reporting. On the other hand, not only do jurisdictions vary in their income tax rates and timing and manner of income tax reporting, there are also countless other differences adding to the complex web of state and local income tax laws. State and local laws differ, for example, in what items qualify as non-business income, as well as allowable deductions, credits and depreciation methods. The amount of time and resources spent researching and collecting data necessary to claim certain state or local deductions and credits alone can be staggering.[6]

Additionally, some states require combined reporting, a single return for all affiliated corporations, while others permit each corporation to file a separate return. Further complicating matters, some combined reporting states require all domestic and foreign affiliates file a single return, while others only require domestic affiliates file a single return. Also, each state has its own formula for calculating the amount of income allocable to it, known as an apportionment formula. Different states may use a different combination of three factors in their apportionment formulas: sales, payroll, and property. Some states

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[6] One employee in the Sherwin-Williams Tax Department estimates he spent 90 hours annually working to comply with the requirements for claiming the Ohio Refundable Jobs Credit, ORC. ANN. § 122.17 (2006). He spends this time coordinating with other departments within Sherwin-Williams, creating databases of information, sorting through documents, and researching changes to the required form and manner of submission of the information. According to this employee, he spends a similar amount of time working on compliance with the requirements of income tax credits for other states.

use all three, some states use two, and some one. States also differ in what items are includable in each factor.

As a result of this greater complexity, Sherwin-Williams' Corporate Tax Department devotes significantly more of its resources to state income tax law compliance versus compliance with state sales tax laws. Sherwin-Williams' Tax Department employs four accountants who devote their entire time on the job to sales tax law compliance. Comparatively, Sherwin-Williams' Tax Department employs seven accountants who devote their entire time on the job to income tax compliance.[7]

The only reason Sherwin-Williams needs four accountants for sales tax is the volume of returns, since sales tax returns are relatively uniform. Conversely, even though there are fewer returns to prepare, Sherwin-Williams needs seven income tax accountants to handle the complexity of income tax returns. Further illustrating the point, the Sherwin-Williams' income tax accountants are employed at a higher grade level than its sales tax accountants: Sherwin-Williams Tax Department spends 25% of its salary budget on income tax accountant salaries, while spending only 12.5% of its salary budget on sales tax accountant salaries.

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[7] The income tax accountants split their time between state and federal income taxes, spending the majority of time working on strictly state issues. It is worth noting that much of the work these accountants do related to federal income taxes is also applicable to state taxes in some way, as many states base at least some of their income tax laws on federal income tax laws. Nebraska, for example, follows the Internal Revenue Code's approach to interest deduction, although with minor modifications. NEB. REV. STAT. § 77-2716 (2007).

Besides accountants, the Sherwin-Williams Tax Department employs five attorneys who spend the vast majority of their time addressing state tax issues addressing income tax issues. The complexity of state income tax law might be best evidenced by the fact that the Sherwin-Williams Tax Department spends a whopping 94% of its state tax litigation budget on litigating income tax issues, while it allocates merely 6% on sales tax issues.

II. The Stakes Are Higher for Multistate Businesses When States Directly Impose Income Taxes on Them Than When States Impose the Duty to Collect Sales or Use Tax on Them, Necessitating a Bright-Line Physical Presence Rule for State Income Tax Nexus.

Besides the greater complexities of and burdens of compliance with state income tax laws, multistate businesses have more at stake when a state asserts nexus to impose a tax on the businesses own income than these businesses have at stake when a state imposes the duty to collect the sales and use tax from their customers. First, in many states, businesses are reimbursed a percentage of the sales tax collected from their customers as compensation for the burdens related to complying with sales tax laws. *See, e.g.,* FLA. STAT. § 212.12(1) (2007) (allowing businesses to retain a percentage of the sales or use tax it collects). Businesses must bear the cost of the burdens related to complying with income tax laws themselves.

Second, businesses bear the cost of the income tax out of their own capital, while merely remitting funds they collect from customers to pay the sales or use tax. Accordingly, a corporation's income tax expense is deducted from its overall earnings while amounts remitted as sales and

use taxes are not. This is of particular importance to multistate businesses like Sherwin-Williams, because shareholders and other investors generally gauge a corporation's health by how much that corporation earns per share.

Shareholders and investors are concerned about a corporation's state income tax expense because that corporation's effective tax rate, the amount of recognized tax expense related to the income earned in a given year,[8] effects its earnings per share: the more income taxes a corporation is expected to pay per dollar of earnings the lower the earnings per share. Thus, shareholders and investors benefit from a precisely calculated effective tax rate because such gives them confidence in their ability to gauge the health of that corporation.

Besides benefits related to investor confidence, corporations benefit from a precisely calculated effective tax rate because such allows a corporation to know more precisely how much capital it will have available for investment, dividends, pension contributions, and salaries, as well as how its shares are priced on the public market. Lenders rely on this information to determine the corporations debt-rating.

Third and most importantly, multistate businesses like Sherwin-Williams have long relied on *Quill* and its ancestors in the absence of a separate ruling for state income tax nexus. Before a state jumped on the economic nexus bandwagon, businesses without physical presence in that state had no reason to file an income tax return in

[8] The effective tax rate is calculated as the year's recognized tax expense divided by the year's profits before tax.

that state. This fact is of great consequence to these businesses because if a business does not file a return the statute of limitations does not begin to run in most jurisdictions. *See, e.g.,* ILCS Chapter 35 § 5/905(C) (2006); N.J. REV. STAT. § 54A:9-4(C)(1)(A) (2006).

As a result and despite these businesses' reasonable reliance on *Quill* and its ancestors, such businesses may be liable for unquantifiable back taxes and interest attributable to long ago tax years. Along with back taxes and interest, states will likely also assess penalties for failure to file a return and for failure to timely pay income taxes due. These penalties are generally calculated as a percentage of the state-claimed back tax liability. *See, e.g.,* HAW. REV. STAT. § 231-39 (2007) (imposing a penalty of as much as 25% of the balance due, for the late filing of a corporate income tax return); ME. REV. STAT. ANN. 36 § 187-B(1)(C) (imposing a penalty of as much as 100% of the assessed taxes for the late payment of corporate income taxes).

Thus, under the current climate of ambiguity, multistate businesses are unjustifiably threatened by constantly compounding tax, interest, and penalty liability. A bright-line physical presence rule would remove this threatened avalanche and would consequently facilitate the interstate growth of multistate businesses like Sherwin-Williams.

III. The Recent Dramatic Rise in Attention to Corporate Financial Accountability Necessitates a Bright-Line Physical Presence Rule for State Income Tax Nexus.

In today's business climate, more than any other time, a bright-line physical presence rule for income tax nexus is

critical to the free flow of interstate commerce. Now, more than ever, multistate businesses must have the ability to determine their income tax expense as precisely as possible. To address recent financial reporting scandals and to better ensure that corporate financial statements are worthy of investors' reliance,[9] Congress, the SEC, and FASB have increased their regulation and scrutiny of financial reporting. A bright-line physical presence rule would further the aims of Congress, the SEC, and FASB in the area of financial accountability by facilitating a more precise determination of multistate corporations' state income tax expenses and effective tax rates, while the current uncertainty surrounding state income tax nexus thwarts their aims.

Of particular relevance is a recent FASB pronouncement, FIN 48. By way of background, FASB is charged with promulgating corporate accounting rules that are binding on businesses like Sherwin-Williams. One such rule is FASB Statement No. 109 *Accounting for Income Taxes* ("FAS 109"). FAS 109 provides guidelines for reporting the estimated amount of income taxes payable or refundable in a current tax year. In 2006, FASB clarified FAS 109 by issuing FIN 48 to address problems related to accounting for contingent income tax benefits.

FIN 48 limits the income tax benefits a corporation can recognize on its financial statement to those arising from tax positions "more likely than not" to ultimately be sustained. For purposes of FIN 48, an income tax position

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[9] Shareholders and other investors rely on a corporation's financial information including its reported income tax expense and effective tax rate to measure the health of that corporation.

is more likely than not to be sustained if it has a greater than 50% likelihood of being sustained on audit. The more-likely-than-not standard simply determines whether the benefit may be reported on the financial statement at all. If the benefit does not meet the more-likely-than-not threshold the company may not recognize a single dollar of the benefit on its financial statement.

If the benefit meets the more-likely-than-not standard, the company still will likely not be able to report the entire benefit on its financial report. Instead, the company may only include the portion of that benefit that is more likely than not to be sustained on audit. The company determines the reportable portion through the use of a complicated probability analysis and must make detailed disclosures of its analysis. In most cases, the end result is that companies will be able to report only a fraction of the tax benefits they expect during the tax year.

FIN 48 also requires that a corporation report potential penalties related to its tax positions as a tax liability, off-setting the benefit of that position, unless the corporation meets the statutory requirement for waiver of that penalty. In the context of state tax, this sometimes means that all potential penalties must be included on the financial statement as a liability because there is no statutory provision for waiver of that penalty.[10] This is particularly onerous because under current conditions, as discussed

[10] In Alaska, for example, penalties may only be waived in the discretion of the Department of Revenue or the Attorney General. ALASKA STAT. § 43.05.070 (2006). Therefore, there is no statutory provision for waiver of the penalty and a company must account for all potential Alaska penalties on its financial report.

above, states may potentially impose enormous penalties on corporations with no physical presence within the state.

For these reasons, the ambiguity surrounding the issue of state income tax nexus interferes with corporations' abilities to conduct themselves in the interstate marketplace. The more uncertainty surrounding an income tax position, the less likely it is that a corporation may recognize the benefit from such a position on its financial statement under FIN 48. As a result, the financial statement may reflect lower earnings per share than reality dictates. Combined with the fact that FIN 48 also requires that corporations reserve for potentially enormous penalties resulting from this uncertainty, until the law in this area is clear, corporations will also likely have less available capital for investment. Finally, the potential liability for failure to file and substantial underpayment penalties, alone, is enough for businesses to think twice before expanding operations interstate.

A clearly articulated physical presence rule for state income tax nexus would go a long way to furthering the ends of FIN 48. Such a rule would reduce uncertainty related to multistate businesses' state income tax positions resulting in a more realistic report of multistate corporations' income tax expense, effective tax rate, and earnings per share.

CONCLUSION

For these reasons, The Sherwin-Williams Company respectfully requests that this Court grant Lanco's petition for a writ of certiorari and reverse the decision of the Supreme Court of New Jersey.

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DIRECTOR, DIVISION OF TAXATION,

Respondent.

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Business Activity Tax Simplification Act of 2003: Hearing Before the Subcomm. on Commercial & Administrative Law of The House Comm. on the Judiciary, 108th Cong., 2d Sess. (2004) 5,6

H.R. Rep. 109-575 (2006) 6

Tenn. S. Ct. R. 4(G)(2) 3

REPLY BRIEF

Respondent urges adoption of a constitutional interpretation that would permit a State to impose franchise and excise taxes on any corporation that "reach[es] into" the State "for business." Br. in Opp. 18. Respondent candidly urges that the Commerce Clause's physical presence requirement should be abandoned to allow a tax that substantially burdens businesses precisely because they engage in interstate commerce. This Court rejected that argument in both *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), and in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

The state courts are deeply divided on this recurring question of the applicability of *Bellas Hess* and *Quill*. That disagreement and its nationwide importance require resolution of the question by this Court.

I. THE NEW JERSEY SUPREME COURT'S RULING BRINGS IT INTO DIRECT CONFLICT WITH OTHER STATE COURTS

A. The court below broadly rejected the *Bellas Hess/Quill* physical presence test as a general requirement for state taxes

Respondent attempts to portray the New Jersey Supreme Court's opinion below as a fact-specific holding that is somehow limited to a particular corporate structure involving inter-affiliate licensing of intellectual property. Br. in Opp. 1-6, 7 n.1. That is contrary to respondent's sweeping argument below, *see* Resp. N.J. App. Div. Br. 39 (respondent urging court below to hold that "*Quill* quite plainly does not apply to taxes other than sales and use taxes."), and respondent's own request that the New Jersey Supreme Court hear the case, *see* Pet. 7 (quoting respondent's assertion that this case involves a "substantial question under the United States Constitution on which there is a divergence of precedent").

Respondent's bait-and-switch tactics do not alter the fact that the decision below imposes an expansive rule that the Commerce Clause's physical presence requirement does not apply to *any* state taxes (other than sales and use taxes) for *any* business. The court expressly "agree[d] with the [respondent] Director that *Quill* does not apply to taxes other than sales and use taxes," and that New Jersey's Corporation Business Tax may be constitutionally applied to impose a tax on a company's income from licensing fees attributable to New Jersey, notwithstanding the company's "lack of a physical presence in New Jersey." Pet. App. 11a, 3a (citation omitted)

Respondent needed the courts below to reject the *Quill* physical presence test because, as the New Jersey Tax Court determined based on stipulated facts, petitioner Lanco is a Delaware corporation that has no physical presence in New Jersey. *Id.* at 22a. Lanco's customer, Lane Bryant, Inc., is a retailer who has clothing stores in New Jersey. Lanco licenses its intellectual property to Lane Bryant in exchange for royalties. There is no dispute that Lane Bryant has a physical presence in, and may be taxed by, New Jersey.

B. The ruling below widened a conflict among state appellate courts

The New Jersey Supreme Court acknowledged that its ruling widened "a split of authority" that has "developed regarding whether the Supreme Court's holding [in *Quill*] was limited to sales and use taxes." Pet. App. 2a. Indeed, respondent below recognized the split. *See* Resp. N.J. App. Div. Br. 49 (respondent arguing that "State court authority is split on whether the physical-presence test of *Quill* applies outside the sales and use tax context"); Pet. 7.

The court below pointed to *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *appeal denied*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000) (per curiam), *cert. denied*, 531 U.S. 927 (2000), as a ruling in

conflict with its own, but respondent contends (Br. in Opp. 7-8) that it is merely an intermediate state court decision without broad precedential value. That understanding of the precedential effect of the decision is wrong. Under settled state procedures (which are different from those followed by this Court), the Tennessee Supreme Court has affirmed the decision by denying an appeal and allowing the decision to be published. *See* Pet. 10.[1]

Also, as already demonstrated (Pet. 11-12), state appellate courts in Michigan and Texas have adopted a reading of *Quill* that cannot be reconciled with the decision below. Respondent's contention that the "factual paradigm" of those cases differs from this one (Br. in Opp. 8) is irrelevant. Importantly, respondent does not dispute that those cases hold "that *Quill* established a physical presence requirement for the imposition of all State taxes." *Id.* at 9. Indeed, each of those decisions announced a broad rule about the test to determine whether there is the constitutionally required "substantial nexus" to support state taxation jurisdiction, none is limited in any way suggested by respondent, and each is now binding law in the State in which it was issued.

The fact that state courts in New Jersey and elsewhere have increasingly misread *Quill* in recent cases may be explained, at least in part, by the difficulty that a state court faces in invalidating its own State's claims of tax jurisdiction

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[1] The subsequent unpublished opinion in *America Online, Inc. v. Johnson*, 2002 WL 1751434 (Tenn. Ct. App. July 30, 2002), did not call *J.C. Penney* into doubt. *America Online* does not have the force that *J.C. Penney* has because *America Online* was not appealed to the Tennessee Supreme Court and because it is not published, which means that, under Tennessee law, it has no force as precedent. *See* Tenn. S. Ct. R. 4(G)(1). In any event, *America Online* addressed only whether particular conduct met the "physical presence test," which, as described in the petition, includes certain activities performed in state on behalf of the taxpayer. *See* 2002 WL 1751434, at *3; Pet. 2 n. 1.

over out-of-state entities in light of actions already taken by sister States that allow such taxation in comparable circumstances in that other State. Because the Tax Injunction Act precludes the lower federal courts, which are designed to ensure attention to federal interests in such instances, from passing on the significant constitutional question presented here, this Court is the only federal forum in which this important federal issue can be resolved.

C. Petitioner is only one of the many types of companies that lack a physical presence in New Jersey that the respondent seeks to tax

Respondent goes to great lengths to insinuate that petitioner engaged in an improper tax avoidance mechanism. That attack is both irrelevant and without merit. The parties stipulated that transactions between petitioner and its licensee were made at "arm's length rates," Pet. App. 53a, respondent never questioned the *bona fides* of Lanco, and no argument about tax planning was ever addressed below. In separate tax litigation in New York, petitioner Lanco was found to be a "viable corporation[]" formed for numerous legitimate business reasons apart from tax planning and that it engaged in "extensive activities" regarding "the registration and protection of the trademarks it owned." *In re Express, Inc.*, 1995 WL 561501, at *33 ¶F, *3 ¶9-11, *4 ¶22 (N.Y. Div. Tax App., Sept. 14, 1995). Indeed, if Lanco were not distinct from Lane Bryant, then respondent New Jersey already has the constitutional authority to attribute Lanco's income to Lane Bryant, Inc., the in-state taxpayer. *See* Pet. 23 n.9.

Respondent also argues that the New Jersey Supreme Court decision is limited to the licensing of intellectual property between related companies, but the court's decision does not so indicate. And respondent does not provide any principle that could legally distinguish, for purposes of state taxation, the licensing of intellectual property to an out-of-

state customer from, for example, the sale of tangible goods through the mail or the provision of credit card services at issue in *MBNA America Bank, N.A. v. Tax Commissioner*, No. 06-1228, pet. for *cert.* pending. The Commerce Clause is neither industry nor tax specific; it applies to all manner of commerce and taxes.

Indeed, New Jersey's statements and actions reflect this understanding through its practice of asserting jurisdiction to tax all types of corporations, without regard to the physical presence requirement of *Bellas Hess/Quill*. For example, New Jersey has attempted to tax a software development company with no physical presence in New Jersey based solely on the fact that it sold seven software licenses in the State. *See Business Activity Tax Simplification Act of 2003: Hearing Before the Subcomm. on Commercial & Administrative Law of the House Comm. on the Judiciary*, 108th Cong., 2d Sess., at 85 (2004) (statement of Rep. Goodlatte); Pet. 4 n.2. Also, respondent's counsel expressly represented that the outcome of this case would determine, for example, whether New Jersey could tax "companies that conduct seminars for people in New Jersey without actually sending an instructor to the State," but use the television or the internet instead.[2]

Finally, as discussed in the petition (at 17) and the brief of the Clearing House Association *et al.* as *amicus curiae* (at 12-13) in the pending petition in *MBNA America Bank, N.A. v. Tax Commissioner*, No. 06-1228, New Jersey already has begun circulating "nexus surveys" to foreign affiliates of corporations incorporated in the United States. That action suggests that New Jersey also intends to apply the ruling

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[2] *See* video of N.J. Sup. Ct. Oral Argument (Sept. 12, 2006), at 30:20-30:55, *available at* http://njlegallib.rutgers.edu/supct/args/A_89_05.php.

below to companies that lack a physical presence in *any* of the States.

Such aggressive efforts are not limited to New Jersey. Congress has documented efforts by States across the country to tax companies that lack any physical presence within that State. *See* H.R. Rep. No. 109-575, at 7-8 (2006) (banks who issue credit cards to state residents); House Hearing, *supra*, at 65, 85 (media corporations that broadcast programs into the State); *id.* at 85 (health care providers performing services for state residents); *ibid.* (corporations registering to do business in State); *id.* at 86 (corporations listing phone number in in-state phone book).

This persistent danger of overreaching States disrupts settled expectations of businesses that seek to serve customers across state lines. Respondent asserts, astoundingly, that "there are no 'settled expectations' in business." Br. in Opp. 17. But the brief of the Greater Philadelphia Chamber of Commerce and the Chamber of Commerce Southern New Jersey as *amicus curiae* emphasizes that a recent ABA draft white paper explains that "most interested parties" understood this Court's cases in *Bellas Hess* and *Quill* "to mean that physical presence was required" in a State to support the State's imposition of "income-type taxes" as well as "sales and use type taxes," and "business decisions were made accordingly." *Id.* at 5 (citing American Bar Association, Section of Taxation, *Draft White Paper on Business Activity Taxes and Nexus* 25 (Jan. 15, 2007)). It is for this reason that *amici* correctly state with great conviction that New Jersey's current post-*Quill* effort to tax companies that lack a physical presence in the State disrupts the expectations of entire industries. *See id.* at 5-11; Brief of The Sherwin-Williams Co. as *amicus curiae* ("Sherwin-Williams *Amicus* Br."), at 1, 3, 11-12.

II. THE STATE LAWS CITED BY NEW JERSEY INCREASE, RATHER THAN DIMINISH, THE NEED FOR IMMEDIATE REVIEW OF THE DECISION BELOW

Respondent suggests (Br. in Opp. 9-12) that legislative changes in some States make the question of whether respondent has the authority to tax petitioner less relevant. That is wrong. In fact, those statutes make this Court's review even more critical.

Respondent notes (*id.* at 9-10) that New Jersey, and other States, have enacted legislation to preclude taxpayers with a physical presence in the State, such as Lane Bryant, Inc., from deducting from their income any payments for the use of intangible property that they make to a related company, such as petitioner, that lacks a physical presence in the State. Thus, Lane Bryant, Inc., the retailer who was petitioner Lanco's licensee and was undisputedly subject to tax in New Jersey because it is physically present there, would, under that law, be required to pay tax on the very same money that constituted petitioner's income. Such legislation demonstrates that there are alternate mechanisms available to States to address their perceived problem without violating the Commerce Clause's physical presence requirement.

But respondent New Jersey is not satisfied with taxing corporations that have a physical presence in the State. Respondent insists that it can *also* tax petitioner Lanco for the very same income received from Lane Bryant, Inc. Thus, it is New Jersey's position that under the New Jersey Supreme Court's holding, it may tax Lanco's income twice, first as Lane Bryant's nondeductible payment to Lanco and then as Lanco's revenue. Respondent already has taken such a position against other companies that lack a physical presence in New Jersey but license intellectual property to related companies with such a physical presence. *See, e.g.*, *Federated Brands Inc. v. Director*, N.J. Tax Ct. No. 008806-2006, complaint filed December 7, 2006 (challenging such

multiple state taxation). That hardly is a cure to the problems identified by the petition.[3]

III. INTERSTATE COMMERCE WILL BEAR ENORMOUS COMPLIANCE COSTS IF THE PHYSICAL PRESENCE REQUIREMENT IS ABANDONED

A. In *Quill*, this Court recognized the need for a bright-line test to determine the ability of States to tax businesses that offer goods or services to residents of multiple States. The easy applicability of the physical presence requirement explains why it has been adopted by the United States in many international tax treaties. Pet. 17-18.

Although respondent urges that income and franchise tax compliance is less burdensome than sales tax compliance (Br. in Opp. 15-16), *amici* demonstrate that the costs of complying with state income and franchise taxes are even greater than the compliance costs this Court found sufficient in *Quill* to retain the physical presence requirement. It is undisputed that more than 8,000 jurisdictions in the United States have the authority to impose an income, franchise, or gross-receipts tax. Pet. 21-22. Contrary to respondent's claim (Br. in Opp. 15), many income-taxing jurisdictions require multiple income tax filings each year. *See* Sherwin-Williams *Amicus* Br. at 7. Moreover, there is a vast array of differences across taxing jurisdictions in determining income, in procedural requirements, and in record-keeping. *See* Brief of Council on State Taxation, National Association

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[3] Respondent also ignores the fact that several States whose courts have abandoned the physical presence requirement of *Bellas Hess/Quill*, such as West Virginia, South Carolina, and Louisiana, have not enacted such statutes. *See* Br. in Opp. 4-6, 10. Also, respondent notes that some States require "combined reporting" for related corporate entities, Br. in Opp. 11, but that is merely another possible mechanism available to New Jersey to impose a tax on the income paid to Lanco. It does not legitimize the State's exercise of taxing authority over petitioner at issue here.

of Manufacturers, and National Marine Manufacturers Association as *amicus curiae*, at 11-12, 10, 15 n.11; Sherwin-Williams *Amicus* Br. at 8-10. Imposition upon businesses of income, franchise, and gross-receipts taxes by every jurisdiction in which they have customers would impose a serious burden on interstate commerce.

Respondent also asserts that *Quill* was only an application of *stare decisis* that should be limited to that case. Br. in Opp. 14-15. But this Court in *Quill* overruled the due process holding in *Bellas Hess, see* 504 U.S. 306-308, at the same time that it reaffirmed the Commerce Clause holding of *Bellas Hess*, making clear that each holding was examined in light of contemporary case law and *stare decisis* was not the only basis for the decision. The Justices concurring in judgment in *Quill* confirmed this reading. *Id.* at 320 (Scalia, J., concurring in judgment).

B. Finally, respondent argues that unless *Bellas Hess* and *Quill* are limited, income of out-of-state corporations will "escape[] State taxation entirely." Br. in Opp. 5. That is wrong. Petitioner is subject to the taxing authority of Delaware, in which it has a physical presence.

New Jersey implicitly criticizes Delaware's decision not to impose the taxes on petitioner that New Jersey now seeks to impose (*id.* at 1-3), but one State's tax laws are not a loophole that another is allowed to close. This is the essence of our federalism that this Court's Commerce Clause decisions protect. *Cf. BMW of North Am., Inc. v. Gore*, 517 U.S. 559, 571 (1996) (State is "constrained" under the Commerce Clause "by the need to respect the interests of other States" and cannot "impose its own policy choice on neighboring States"). The constitutional protection that Delaware's tax policy is due does not vary based on whether the income is earned by the licensing of intellectual property for use out of state, or the sale of tangible items for use out of state. Respondent asserts that it would only be "fair" to allow it to tax petitioner, Br. in Opp. 18, thereby candidly

urging that state boundaries should no longer matter, but, of course, in our federal system, they matter very much.

Few issues are as unsettled and important to the business community as the question of the continuing applicability of the rule that a State has taxing jurisdiction over a company only if the company has a physical presence in the State. That question is presented by this case and by the *MBNA* case also currently pending on petition for *certiorari*. As urged in our petition (at 30), both cases should be granted review and heard in tandem. If this Court grants *certiorari* only in *MBNA*, then the instant case must be held pending the resolution of *MBNA* and then disposed of accordingly.

CONCLUSION

For the reasons set forth above and in the petition for a writ of *certiorari*, the petition should be granted.

Respectfully submitted,

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Supreme Court of the United States

FIA CARD SERVICES, N.A., FKA MBNA AMERICA BANK, N.A.,
Petitioner,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
Respondent.

LANCO, INC.,
Petitioner,

v.

DIRECTOR, DIVISION OF TAXATION,
Respondent.

On Petitions for Writ of Certiorari to the West Virginia Supreme Court of Appeals and Supreme Court of New Jersey

BRIEF *AMICI CURIAE* OF COUNCIL ON STATE TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS AND NATIONAL MARINE MANUFACTURERS ASSOCIATION IN SUPPORT OF PETITIONERS

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QUESTION PRESENTED

Whether the Commerce Clause bars a state from imposing income and franchise tax on an out-of-state company engaged in interstate commerce, when that company has no "physical presence" in the state.

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INTEREST OF *AMICI CURIAE*

This brief *amici curiae* in support of petitioners is filed on behalf of three trade associations representing the largest businesses in our nation's state and local economies.[1] Unless this Court clarifies whether in-state physical presence remains the standard by which a business becomes subject to a state's income and franchise tax jurisdiction, the thousands of members of *amici*'s associations will face substantial costs in determining their tax liabilities and in some instances will not be able to ascertain those liabilities accurately at all. This uncertainty regarding tax compliance obligations will create significant and impermissible burdens on interstate commerce.

The Council On State Taxation ("COST") is a non-profit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST represents nearly 600 of the largest multistate businesses in the United States, including companies in every industry. Many of COST's members have customers in states where the members have no property or employees – that is, in states where the members have no "physical presence."

The National Association of Manufacturers ("NAM") is the nation's largest industrial trade association, representing small and large manufacturers from all 50 states, many with multistate operations. NAM's mission is to enhance U.S. manufacturing competitiveness by shaping a legislative and regulatory environment conducive to economic growth and to increase understanding among policymakers, the media and

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity other than *amici curiae* has made a monetary contribution to the preparation or submission of this brief. Written consent of all parties to the filing of this brief has been obtained and filed with the Clerk of this Court.

general public about the vital role of manufacturing to America's economic future and living standards.

National Marine Manufacturers Association ("NMMA") is the nation's largest recreational marine industry association, representing more than 1,600 boat builders, engine manufacturers, and marine accessory manufacturers. The recreational boating industry is a substantial contributor to the nation's economy with sales of recreational marine products and services totaling more than $37 billion in 2005 alone. Because their business activities are typically multistate in nature, the NMMA's members have an important interest in the question presented.

SUMMARY OF ARGUMENT

Historically, a corporation's physical presence in a state served as the prerequisite for any type of tax, including income and franchise tax. In *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 754 (1967), and *Quill v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed the physical presence rule in the context of sales and use taxes.

However, some states are aggressively seeking to increase their tax revenues by asserting the power to tax the corporate income of out-of-state businesses that have no physical presence in the taxing state. The states have adopted a variety of "nexus" standards through judicial, legislative, and administrative action. These standards, which are ill-defined and differ from state to state, have highly burdensome implications for taxpayers doing business in multiple jurisdictions and thus place heavy burdens on interstate commerce. Yet the highest courts of West Virginia, New Jersey, South Carolina, and Ohio have all held that the Commerce Clause does not prevent the imposition of income and franchise taxes upon out-of-state corporations with no physical presence in the state. State appellate courts have issued similar decisions.

These cases warrant this Court's review not simply because of the conflict among state courts regarding the meaning of the Commerce Clause in the context of corporate income and franchise taxes. Rather, this Court's review is urgently needed because departures from the physical presence rule and the resulting uncertainty over the jurisdictional grounds of state taxation have themselves generated an impermissible burden on interstate commerce. Thus, these cases present the special circumstance where divergent approaches by different states have produced the very constitutional evil that the Commerce Clause was meant to avoid.

The uncertainty in calculating a multistate business's state income or franchise tax liability stems both from (i) the divergent approaches taken by different states and (ii) the nebulous and unpredictable nature of alternatives to the physical presence rule. The uncertainty generates a considerable increase in compliance costs and administrative burdens, as well as problems in determining and reporting the business's tax liability for required financial statements. A business that cannot accurately ascertain its tax liability, even internally, can hardly be expected to make meaningful disclosures to investors. As a result, there is real economic loss when a company decides not to exploit an otherwise profitable opportunity (such as expanding its business into a new state) because of the expense and uncertainty inherent in state tax jurisdiction rules. The abandonment of the traditional "physical presence" rule thus entails deadweight losses (in the form of unnecessary compliance costs), lower business productivity, slower growth, fewer jobs, and additional burdens on interstate commerce.

The same reasons that animated this Court's grant of review in *Quill* militate strongly in favor of certiorari in these cases. In fact, the need for this Court's plenary review is much more compelling here than in *Quill* because state corporate income taxes are more burdensome than sales and

use taxes. The costs of compliance are much greater, and the threat to interstate commerce is more immediate. The number of potential taxing jurisdictions at the state and local level authorized to impose business activity taxes is double the number imposing sales and use taxes. Certiorari is amply warranted.

ARGUMENT

I. UNCERTAINTY REGARDING STATE AND LOCAL TAX COMPLIANCE OBLIGATIONS CREATES AN IMPERMISSIBLE BURDEN ON INTERSTATE COMMERCE.

A. The Physical Presence Rule Is Necessary To Provide Clarity and Predictability.

Physical presence has traditionally served as the basis for the imposition of corporate income and franchise taxes. In *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967), this Court held that a systematic program of direct mail advertising was not sufficient to justify imposition of a use tax on an out-of-state seller. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed the physical presence rule in the sales and use tax context as a limit "firmly establish[ing] the boundaries of legitimate state power." *Id.* at 315.

The physical presence rule is a bright-line rule that provides a business with an adequate understanding of when and where it will be subject to tax. As a leading constitutional scholar has observed, the rule "provides some measure of stability to parties engaged in commercial interchange and provides a more hospitable environment for the flourishing of nascent modes of free-floating interstate commerce, which might otherwise perish on the rocky shoals of overmuch state taxation." 1 Laurence H. Tribe, AMERICAN CONSTITUTIONAL LAW 1125 (3d ed. 2000).

However, some states have departed from the physical presence rule in the imposition of corporate income and franchise taxes. West Virginia has adopted a "significant economic presence" test, which would permit a state to tax the income of any business with *customers* in the taxing state, even if it lacked any real or tangible personal property, employees, or other contacts there. New Jersey has held that licensing "intangible property" for use within a state creates an economic "presence" permitting taxation. Other states have adopted their own "nexus" standards, whose nebulous nature and non-uniform definitions make it highly burdensome for multistate businesses to comply. *See, e.g., Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225, 1230 (Ohio), *cert. denied*, 519 U.S. 810 (1996) ("the physical-presence requirement of *Quill* is not applicable" to state income tax); *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13, 18 (S.C. 1993) ("by licensing intangibles for use in this State and deriving income from their use here, [taxpayer] has a 'substantial nexus'" with state); *see also Buehner Block Co. v. Wyo. Dep't of Revenue*, 139 P.3d 1150, 1158 n.6 (Wyo. 2006).[2] Still other states have made statutory or administrative changes asserting authority to tax corporations with no physical presence.[3]

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[2] *See also Kmart Props., Inc. v. Taxation & Revenue Dep't of N.M.*, 131 P.3d 27, 35 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22 (N.M. 2005); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194-195 (N.C. 2004), *certif. denied*, 611 S.E.2d 168 (N.C.), *cert. denied*, 126 S. Ct. 353 (2005); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632, 638 (Okla. Civ. App. 2005); *Gen. Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1029 (Wash. App.), *pet. rev. denied en banc*, 84 P.3d 1230 (Wash. 2001), *cert. denied*, 535 U.S. 1056 (2002).

[3] *See, e.g.*, Ark. Reg. 1996-3; Fla. Admin. Code Ann. r. 12C-1.011 (p)1 (2007); Iowa Admin. Code r. 701.52.1(422), 52.1(1)d (2007); Directive 96-2 (Mass. Dep't of Revenue July 3, 1996); Minn. Stat. § 290.015(1)(c)(3) (2005); Okla. Admin. Code § 710:50-17-3(a)(9) (2005); Wis. Admin. Code Tax § 2.82(4)9 (2007).

As states adopt their own versions of a "nexus" test, multistate taxpayers face a variety of different standards and vague guidelines. Taxpayers are denied a clear understanding of their tax liabilities, and even whether they are required to pay tax in a jurisdiction at all. "The economic nexus theory raises the possibility of such a steep slippery slope of application that it would be virtually impossible to come up with the necessary benchmarks that would serve as an efficient, fair and definite standard to determine state and local tax jurisdiction and a taxpayer's filing obligation. With so many possible applications, it is also unlikely that the states would be able to form a consensus on the boundaries of nexus." Scott D. Smith and Sharlene Amitay, *Economic Nexus: An Unworkable Standard for Jurisdiction*, 2002 STT 174-2, Sept. 9, 2002, at 5-7. For example, a recently proposed bill in New Hampshire would impose a corporate income tax with no guidance as to what activities give rise to economic nexus.[4]

"There are infinite possibilities for establishing nexus when economic/non-physical factors are used as determinants of jurisdiction. Economic nexus is an amorphous concept without clear definitions or boundaries. . . . And, compliance with and administration of a taxing system based on economic nexus is costly and inefficient for both taxpayers and taxing authorities." Smith and Amitay, *supra*, at 2.

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[4] The bill creates a legal standard of "a substantial economic presence evidenced by a purposeful direction of business toward the state examined in light of the frequency, quantity, and systematic nature of a business organization's economic contacts with the state." H.B. 351, 2007 Sess. (N.H. 2007). The definition includes but is not limited to "a group of actions performed by a business organization for the purpose of earning income or profit from such actions and includes every operation which forms a part of, or a step in, the process of earning income or profit from such group of actions." "The actions ordinarily include, but are not limited to, the employment of business assets, the receipt of money, property or other items of value and the incurring or payment of expenses." *Id.*

Accordingly, such uncertainty offends the core values protected by the Commerce Clause and amply warrants this Court's plenary review.

B. Departures From The Physical Presence Rule Create Substantial Compliance Costs For Multistate Businesses.

The abandonment of a physical presence rule will dramatically increase compliance costs. Multistate businesses face the prospect of taxation not only in 50 states, but also in thousands of localities authorized to impose corporate income, franchise and other business activity taxes. A recent Ernst & Young survey found that state and local governments impose over 3,300 business activity taxes.[5] An additional 9,300 U.S. jurisdictions have the power under state law to impose such business taxes but do not currently do so. In the absence of a physical presence rule, multistate businesses will face significant costs in trying to determine the jurisdictions in which they face potential tax liabilities and the applicable rules of those jurisdictions. Some may be unable to ascertain accurately their tax liabilities at all. Each multistate business will have to analyze a long list of issues for every jurisdiction where it has a commercial profile.

1. Return Filing Methods.

At the federal level, there are only two types of income tax returns – separate and consolidated – and taxpayers make an election to file a consolidated return based on carefully identified criteria in extensive regulations. In contrast, the states have numerous types of returns with inconsistent and overlapping names and frequently opaque rules. Further, most of the various types of returns are mandatory, not elective. Some states adopt standard federal consolidated

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[5] "State and Local Jurisdictions Imposing Income, Franchise and Gross Receipts Taxes on Businesses, March 7, 2007" at: http://www.ey.com/global/content.nsf/US/Tax_-_Overview.

reporting concepts. With respect to reporting requirements, 25 states require or allow combined reporting (treating affiliates meeting certain criteria as one taxpayer), and 22 states require or allow separate reporting. 29 states allow or require the filing of consolidated returns that differ in major respects from the federal rules. A cursory list of the issues and variability of state laws regarding the determination of the appropriate type of return includes:

(i) Is combined reporting (including certain affiliated businesses to file as one unit) allowed, prohibited, or elective? Not all states have statues on point, and the issue of a taxpayer's right to file a combined return has been heavily litigated.

(ii) What are the requirements for an affiliate to be included or excluded from the combined report? Does the state require only that the affiliates be unitary? Does the state have some type of additional test such as a requirement that there is some type of distortion in the calculation of a company's income and tax if the calculation is done on a separate return basis? If so, what is considered distortion? Can distortion be rebutted by using the federal income tax rules for determining arm's length pricing for inter-company transactions? If so, does a state adopt all of the federal regulations or does it have its own interpretation of arm's length pricing?

(iii) What are the ownership rules for an affiliate to be eligible for inclusion in the combined report? Requirements vary. Further, what does "ownership" mean? Are there beneficial ownership rules? What types of stock are considered in the ownership test – preferred stock, convertible bonds, restricted stock?

(iv) How are pass-through entities treated? Is the pass-through entity included in the combined report if its majority ownership is the combined group? Is only its income allocated to the member included in the tax base or is its total

income included? Does it make a difference if the pass-through entity is a general partnership, limited partnership, limited liability partnership, or real estate investment trust?

(v) Generally, only affiliates involved in a "unitary business" may be included in one combined return. What is the definition of a "unitary business" in any given state – the "contribution and/or dependency test," the test articulated in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), the test cited in *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), or a state-created test? The latter are sometimes in a statute, sometimes in case law and often consider such issues as whether the affiliates are in the same line of business, the control exerted by the parent corporation, and the sharing of back-office services.

(vi) What types of entities and business may or must be included in a combined return and which must be excluded?[6]

(vii) If a state follows the traditional federal consolidated return rules, are only affiliates that have a nexus (however defined) with the state included in the return, or is the entire federal group included?

2. Filing Requirements and Mechanics.

Once the type of return to be filed is determined, the taxpayer must determine the time frames for filing and paying the taxes, obtaining a refund, or seeking an extension.

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[6] May an insurance company be included with its non-insurance affiliates? Must a company with less than 20% of its property or payroll in the United States be included? Are affiliates in Puerto Rico included? Must foreign entities that do no business in the United States be included? If a foreign entity has income from the U.S. but does not have a permanent establishment in this country, is it included in the combined return with its domestic affiliates? Some state statutes mandate that foreign entities doing business in certain countries be included in a combined return with domestic affiliates. Are new acquisitions included or prohibited? If new acquisitions are not immediately included in the combined return, when are such acquisitions added?

(i) Some states piggy-back onto federal extension filings while others require separate applications for an extension of time to file a tax return.

(ii) A taxpayer must determine the type of rules and software that are required for filing the return and paying the tax. Must the return be filed electronically? Must the payment be sent electronically? What happens if there is an error in the submission that is not the taxpayer's fault? What type of confirmation must the taxpayer keep of its electronic submissions?

(iii) What are the deadlines for filing estimated tax payments? Are payments due ratably throughout the year, or are different percentages of tax due at different estimate dates? What happens to short tax years with respect to estimated payments?

(iv) What are the procedures for amendments and adjustments?[7]

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[7] For example, what are the deadlines for filing an amended return? If a taxpayer has a federal income tax adjustment, when must that adjustment be reported to the state? If such an adjustment is made, and the statute of limitations on the state return would otherwise have expired, may the state examine the entire return or only the issues affected by the federal adjustment? If an amended return includes a refund, does the state have to respond within a certain number of days or is there a "deemed denial" provision? If the taxpayer is under audit, may the refund be filed with the auditor or must an amended return with the refund calculation be filed apart from the audit activity? What is the timing for filing an appeal from a denial of a refund? What is the statute of limitations on audit and assessment versus filing a refund claim? Is the interest rate on overpayments and underpayments the same or different? If a taxpayer overpaid in one year and underpaid in another, is netting allowed? To what judicial or administrative body does an appeal go? Can the taxpayer handle the case itself; may an outside accountant handle the case; or must a lawyer handle the appeal? At what stage are the facts made on the record? Does the body hearing the factual presentation of a case follow the rules of evidence? Can the state appeal an adverse ruling or is it bound by such a ruling?

3. Tax Base Computations and Adjustments.

Multi-jurisdictional taxpayers also face differing state definitions of the tax base. Most states use federal taxable income as a starting point, but five states do not. Even among the states that use federal taxable income as the starting point, almost all have significant addition and subtraction modifications that result in a substantial divergence in the ultimate state tax base from federal base (and among the states' bases themselves). Corporations typically must keep numerous schedules for each state to track the differences in asset and liability basis, net operating losses (NOLs), depreciation, and other variations from the federal rules. Issues that must be considered include:

(i) Does the state follow federal depreciation rules? Many states have departed from the federal bonus depreciation in recent years. This means taxpayers must keep at least two sets of calculation on depreciation. If the state varies from federal rules, what happens when an asset subject to different depreciation rules is sold?

(ii) How does a state calculate NOLs? Does it follow the federal carryback and carryforward rules, or does it have its own time period? Many states do not allow any carryback of NOLs. Further, many states have a shorter carryforward period than the federal rules. Thus, a taxpayer may have many different NOL calculations in many different states, none of which resembles the federal NOL amount.[8]

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[8] Does the state arbitrarily limit the amount of NOLs that can be taken in any one year – through a cap or through a percentage of the total NOLs available? Can state NOLs in a given year exceed those used at the federal level? How are NOLs applied to a group filing a combined return? What happens if the group filing the combined return is a different group than filed a federal consolidated return (which is frequently the case)? Generally, the taxpayer must recalculate a pro forma or "as if" federal return using its state group. How does a state deal with a company entering a combined group with NOL carryovers? How are NOLs allocated among members of a combined group?

(iii) How does a state treat dividends from affiliates? Does it use the same percentages and stock ownership rules as the federal government? (Generally, the answer is "no"). What percentage of ownership is required to obtain a dividend received deduction? What is the treatment of dividends received from members of a combined group, and of dividends received from a foreign unitary affiliate that is not included in the combined return?

4. Income Apportionment and Allocation.

The concept of allocation and apportionment does not exist at the federal level and thus is a unique burden created by state tax laws. Over the years, states have adopted an increasingly varied set of rules for these issues. "Apportionment" generally means how the income from typical activities of a taxpayer is spread out among the taxing states. A formula is used to determine the percentage of income subject to tax in each state. Historically, an equally weighted three-factor formula consisting of property, payroll, and sales was used to determine the business activity, and thus the percentage of taxable income, that each state could claim. However, states now vary the elements included in the formula, their definitions, and their respective weighting. Currently, 9 states still weigh the three factors equally; 17 states double-weight the sales factor; 5 states place a greater weight on the sales factor; 7 states use a single sales factor; and 9 states have different formulas depending on the type of sales or industry (manufacturing, sale of services, etc.). Other issues include:

(i) What items are included in the "property" factor?[9]

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[9] Is property in transit (for example, a desk moving from an office in one state to another) included and if so, to which state is its value assigned? Where is the value of movable property, such as trucks and railcars, assigned? Is extra-territorial property such as satellites included? Is intangible property included (traditionally it has not been, but that is changing, particularly for taxpayers identified as financial institutions)?

(ii) How is property valued? The historic rule is cost basis (with no depreciation), but some states have moved to a fair market value approach.

(iii) What and who is included in the "payroll" factor? Are non-cash benefits included? Is deferred compensation included? Are the salaries of the officers and directors included? To what jurisdiction is an employee's salary assigned? What if the employee has no permanent office but telecommutes, or spends all of his or her time on the road traveling between clients in five different states? Is the compensation of a taxpayer's independent contractors included?

(iv) What is included in the "sales" factor? To what jurisdiction are sales of services and intangible property assigned? Traditionally, they were attributed to the jurisdiction where the majority of the cost of performance in providing the service or intangible was incurred. However some states have adopted a market rule and look to where the customer is, even for sales of services and intangibles. The variation increases the burden on taxpayers.[10]

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[10] If the cost-of-performance rule is required, what types of expenses are included in the "cost" – back office costs, advertising, shipping? Does the cost-of-performance rule require that more than half of the cost be incurred in a single jurisdiction, or is it permissible to assign receipts to the jurisdiction that has a plurality of the costs? May payments made to third parties be included in cost of performance calculation? If so, how does a taxpayer determine where that third party performed the service? If a market rule is required, how is the location of the customer determined? What if the service, such as a computer service, can be accessed by the taxpayer's customers simultaneously at many different sites? What if the intangible property generating the receipt is used in several different places at once – such as a trademark? What if the location of the customer cannot be determined? What if the receipt is from the sale of tangible personal property, and the customer located in another state takes delivery at the taxpayer's warehouse? Does it matter if the customer uses its own truck or a common carrier?

(v) Do certain industries, such as manufacturing, receive a special apportionment formula, such as a single sales factor formula, as an incentive to relocate, expand, or remain in the state, and if so, how is that industry defined? Are certain industries assigned apportionment formulas different from the standard formula because of a unique business model – such as financial institutions, trucking companies, or broadcasting companies? And if so, can businesses with non-standard apportionment formulas be included in a combined report with unitary affiliates using the standard formula?

(vi) When is a taxpayer required to apportion its income among all of the states in which it does business (i.e., business income)? When must it allocate its income from a certain transaction to one state (i.e., non-business income)? What is the definition of business income? While a standard definition has existed for decades in the Uniform Division of Income for Tax Purposes Act ("UDITPA"), many states have not adopted the model Act, and some states have made statutory modifications (such as changing an "or" to an "and"). Some states have abandoned the business/non-business distinction entirely and adopted the nebulous approach of apportioning all income that may constitutionally be apportioned. Do the proceeds from the complete liquidation of a line of business qualify as business or non-business income? Does it matter if such proceeds are reinvested into the remaining business or paid as a dividend to shareholders? What is the definition and scope of a line of business?

(vii) If a taxpayer must allocate its income from a certain activity to one state, which state is it? Is it the taxpayer's state of legal domicile, or the state in which it has its headquarters? Is it the state where the majority of the transactions took place leading up to the sale generating the receipt? If property was sold, is it the state in which the property was located?

(viii) What are the statutory rules for applying an apportionment formula that differs from the statutory

formula? UDITPA contains a provision for changing the formula if the standard formula does not accurately reflect where the income was actually earned. Has the state adopted this rule? How does a taxpayer apply for an alternative formula and what evidence must it present? Can the state impose an alternative formula under the same theory? What types of alternatives are available? May the taxpayer exclude one factor? May the taxpayer add items to a factor that are not usually included – such as adding the value of intangible property to the property factor? What is the burden of proof? In some states the burden of proof is preponderance of the evidence while in other states it is clear and convincing evidence.[11]

* * *

By itself, this list of questions is burdensome. But the abandonment of the "physical presence" rule compounds the burden by multiplying the number of jurisdictions in which a multistate business must resolve the uncertainties. Technology alone cannot solve the problem, because the ambiguities require human analysis and judgment. A potential taxpayer must answer these questions in every state and locality in which it conceivably has an economic nexus – a truly daunting task in light of the 12,600 jurisdictions that have the authority to impose a business activity tax. A company may need to plan several different compliance

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[11] This list of issues is not exhaustive. Added burdens stem from the cost of maintaining adequate documentation, which is multiplied as the number of taxing states increases. Further issues arise when the state tax is based on something other than income – such as assets, paid-in-capital, or gross receipts. In addition, the complexity does not end when the return is filed. Large corporations are under almost continuous audit by many states. The more jurisdictions in which the company is required to file and pay tax, the more audits to which the company will be subject. Audits require answering numerous documentation requests, conducting interviews with employees, and entering into negotiations and potential litigations. All of these items carry significant direct costs and also reduce productivity.

scenarios in hundreds or thousands of jurisdictions in order to assess its potential tax liability.

Further, because systems for apportioning and allocating income are not perfect, increasing the number of taxing jurisdictions will exacerbate the risk of multiple taxation. One commentator has found that a credit card company doing business in only three states would pay tax on 133.5% of its revenues.[12] The multiple taxation burdens will only grow more severe as more states apply inconsistent "economic presence" criteria to out-of-state taxpayers.

Without the physical presence rule, businesses will have to monitor every state and locality in which they have any type of commercial profile. They will be required to track state tax legislation and regulatory developments constantly, become familiar with potential changes in tax law, and stand ready to implement those changes accordingly. Studies show that state income tax compliance costs are already significant, amounting to double the costs of federal tax compliance, when computed relative to the respective tax liabilities.[13] Departures from the physical presence rule will only make the problem worse and will trigger a significant impact on interstate commerce.

C. Uncertainty Leads To Substantial Opportunity Costs.

The additional compliance burdens attributable to uncertainty have real and substantial opportunity costs as well, magnifying the harm to interstate commerce. For

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[12] R. Todd Ervin, Comment, *State Taxation Of Financial Institutions: Will Physical Presence Or Economic Presence Win The Day?*, 19 VA. TAX. REV. 515, 530 (2000).

[13] Sanjay Gupta and Lillian Mills, *How Do Differences in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, Mar. 2002, at 4. For the largest 1,000 firms, the ratio of state compliance costs to state income tax expenses is 2.9%, or more than twice the federal ratio of 1.4%.

example, a company deciding whether to expand its operations in a multistate fashion will necessarily consider whether the additional cost and complexity of tax compliance outweigh the business benefits of expansion. At the margin, the uncertainty caused by departures from the physical presence rule will tend to cause companies to choose business activities that avoid compliance costs but are of lesser value to the business, society and the economy. Such a choice, inherent in any system that requires taxation, is exacerbated as the costs of compliance increase.

Such market distortions are exactly what the Commerce Clause was meant to prevent. The national economy is artificially constricted when a company does not enter new jurisdictions even though there is demand for the company's product, or does not pursue a new line of business at all because it would subject the company to the jurisdiction of additional states under a vague "economic presence" standard. The inherent uncertainty caused by departures from the physical presence rule will aggravate the distortions in economic choice.

D. The Impact on Small Businesses Will Be Severe.

Although these cases deal with large corporate taxpayers, the effects on small and mid-sized businesses of abandoning the physical presence rule will be severe. Smaller businesses do not have the resources or capability to comply with the multitude of state and local tax laws that are certain to be triggered by the economic nexus standard. For example, one study determined that for firms with $5 million or more in assets, the "average total compliance costs systematically increase with increasing firm size as measured by asset size."[14] "Consistent with all earlier research, compliance

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[14] Joel Slemrod and Varsha Venkatesh, *The Income Tax Compliance Cost of Large and Mid-Size Businesses: A Report to the IRS LMSB Division*, Univ. Mich. Bus. Sch. (Sept. 2002). Firms in the $5 million to $10 million asset category had an average of $35,443 in compliance costs;

costs are regressive in the sense that those costs as a percentage of firm size are higher for smaller firms than they are for larger firms."[15] Thus, abandoning the physical presence rule will have a disproportionate impact on small and mid-sized corporate taxpayers.

II. ABANDONING THE PHYSICAL PRESENCE RULE WOULD FRUSTRATE THE GOAL OF ACCURATE FINANCIAL DISCLOSURE.

Departing from the physical presence rule will also create accounting difficulties and will frustrate the goal of accurate and transparent financial disclosures at the heart of the federal securities laws. A company that cannot accurately predict its state income tax liability, even internally, can scarcely be expected to provide meaningful information to investors.

The problem is made more acute by recent tightening of financial disclosure requirements. In 2006, the Financial Accounting Standards Board (FASB), adopted new rules on accounting for uncertain income tax positions. *FASB Increases Relevance and Comparability of Financial Reporting or Income Taxes: Final Interpretation Reduces Widespread Diversity in Practice*, News Release (FASB), July 13, 2006 ("FIN 48"). FIN 48 provides uniform criteria for the preparation of financial statements and expands the disclosure required regarding uncertainty in income taxes. FIN 48 mandates a "reserve" for 100% of tax items unless it is more likely than not that the company will prevail in litigation on those items. This reserve is of indefinite duration, with interest and penalties accruing annually.

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firms in the $10 million to $50 million category spent $93,876 on average; firms with assets from $50 million to $100 million spent $149,876 on average; firms ranging from $100 million to $250 million in asset size spent an average of $243,492; and firms with $250 million to $1 billion in assets had an average of $1,331,643 in compliance costs. *Id.* at 15.

[15] *Id.*

The abandonment of the physical presence rule along with the adoption of varying "nexus" or "economic presence" standards by different states will create havoc for the financial statements of publicly traded companies. Under FIN 48, a company with customers but no physical presence in a state or locality will be required to decide whether it is "more likely than not" that it will be deemed, after the fact, to lack a requisite nexus with that jurisdiction. Otherwise, the company will be required to accrue the full amount of any potential tax liability. The ambiguous and evolving nature of the concept of "nexus" makes it extremely difficult to decide, to a 50% certainty, whether a company will be deemed to have a nexus in a given state or locality. Taxpayers in identical circumstances could reasonably reach different conclusions. As a result, one taxpayer may accrue a 100% reserve of the potential tax liability while another identical taxpayer may reserve little or nothing at all.

The varying and ill-defined "economic presence" standards adopted by the states will therefore frustrate the goal of providing investors with a realistic picture of a corporation's financial position. Hence, abandoning the physical presence rule disserves the purposes of the securities laws as well as the Commerce Clause.

III. THE SAME CONCERNS THAT LED TO CERTIORARI IN *QUILL* SHOULD LEAD TO IT HERE.

In *Quill*, this Court recognized that anything but a physical presence rule would be an undue burden on interstate commerce, because of the significant cost of compliance with sales and use tax laws in a multistate environment. The same conclusion applies *a fortiori* in these cases, because corporate income tax compliance is substantially more complex and burdensome than the sales and use tax compliance analyzed in *Quill*. In the sales and use tax context, only two broad questions must be asked and answered: Is the item taxable or non-taxable? If the item is taxable, what is the applicable tax

rate? The burdens uniquely associated with uncertainty are few with respect to sales and use taxes, because compliance is straightforward.

In contrast, corporate income tax is demonstrably more complex because there are dozens of independent questions and judgments that must be made in calculating a corporate income tax liability. *See* Part I-B, *supra*. Without a physical presence rule, companies would need to examine these questions jurisdiction-by-jurisdiction, corporate-entity-by-entity, and year-by-year. Record-keeping in the corporate income tax context is also significantly more elaborate than in the area of sales and use, where only the records of sales need be retained. The number of potential taxing jurisdictions at the state and local level that can impose a business activity tax, *see* note 5, *supra*, is double the number of jurisdictions imposing a sales and use tax. *See Quill*, 504 U.S. at 313 n.6.

In addition, corporate income taxes are more onerous because, unlike sales and use taxes, they are borne by the taxpayer itself. A sales tax is automatically passed through directly to the customer. An income tax is not.

For all these reasons, the burdens faced by multistate businesses are significantly greater with respect to corporate income taxes than sales and use taxes. The reasons for granting certiorari in *Quill* are even more compelling here.

CONCLUSION

The petitions for writ of certiorari should be granted.

Respectfully submitted,

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Nos. 06-1228, 06-1236

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In the Supreme Court of the United States

FIA CARD SERVICES, N.A.,
FKA MBNA AMERICA BANK, N.A.,
Petitioner,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Appeals of West Virginia

LANCO, INC.,
Petitioner,

v.

DIRECTOR, DIVISION OF TAXATION,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of New Jersey

BRIEF OF GREATER PHILADELPHIA CHAMBER OF COMMERCE and CHAMBER OF COMMERCE SOUTHERN NEW JERSEY AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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STATEMENT OF INTEREST OF *AMICI CURIAE*

Amici Curiae the Greater Philadelphia Chamber of Commerce ("GPCC") and the Chamber of Commerce Southern New Jersey ("CCSNJ") (collectively "*amici*") are non-profit advocacy groups promoting the interests of their regional business communities.[1] They represent over 6,500 businesses and professionals located across southeastern Pennsylvania, southern New Jersey, and northern Delaware. Small businesses with fewer than 100 employees, many of them in service industries, comprise eighty-five percent of their members. The remaining fifteen percent are their regions' leading corporations, including financial institutions. These businesses regularly engage in interstate commerce, both regionally and nationally.

GPCC's and CCSNJ's interest in these cases stems from *amici's* dedication to ensuring that businesses in their tri-state region are not burdened by state tax policies that adversely impact the competitive climate within which those businesses operate and thus limit their opportunities for economic growth. The decisions at issue here endorse just such a policy and run counter to this Court's longstanding jurisprudence concerning the dormant Commerce Clause - which requires a state taxing an out-of-state business to establish a "substantial nexus" to the activity being taxed through the ***physical presence*** of the business in the state.

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[1] All parties have consented to the filing of this brief through letters filed with the Court. This brief was not authored in whole or in part by counsel for any party, and no person or entity other than *amici*, their members, or their counsel made a monetary contribution to the preparation or submission of the brief.

The West Virginia Supreme Court of Appeals and the New Jersey Supreme Court have added to a deepening conflict among state courts by allowing the assessment of net income and business franchise taxes upon an out-of-state business that undisputedly has no physical presence in the state: no offices, no employees, no agents, and no tangible property. Like other state courts that have approved the exportation of tax burdens to out-of-state businesses, these courts have attempted to justify their divergence from established law by asserting that state income-based taxes may be imposed upon entities that have a so-called "economic presence" in the state.

If this Court does not intervene to prevent the "economic presence" concept from becoming an accepted basis for state income taxation, the business community will suffer considerably, both in greater Philadelphia and nationwide. All GPCC and CCSNJ members will be strained by the wasteful costs of compliance with taxation in states where they have no physical presence, and will be well-advised to reconsider providing services to customers there. The economic costs for small businesses, especially, may leave no other choice.

These cases thus present the precise type of burden upon the free flow of trade that the Commerce Clause was intended to prohibit, and that GPCC and CCSNJ are dedicated to attempting to prevent. For these reasons, as amplified below, *amici* respectfully urge the Court to grant the petitions and reaffirm that a showing of physical presence is required before a state may impose an income tax upon an out-of-state business.

SUMMARY OF ARGUMENT

The business community has long and justifiably relied upon this Court's modern era Commerce Clause jurisprudence, which has consistently required a showing of tangible ***physical presence*** (*e.g.*, offices, employees, agents, property) to support an exercise of state taxing authority against an out-of-state business. Indeed, this Court has never approved a finding of a substantial nexus for taxation purposes where the business had no in-state physical presence. The contrary holdings of the West Virginia Supreme Court of Appeals and the New Jersey Supreme Court - that a mere "economic presence" satisfies the requirements of the Commerce Clause for income taxation - are part of a recent trend of state court decisions departing from the established rule that are doctrinally unsupportable.

Alteration of the physical presence test for determining potential income tax liability would upset settled expectations flowing from this Court's decisions in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977); and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). This bright-line requirement is also far superior, as a matter of good tax policy, to the amorphous "economic presence" standard espoused by the decisions at issue and certain others.

The physical presence rule is simple to enforce and easy to predict. It also promotes economic growth by limiting the number of states taxing a single entity and freeing business resources to be invested more productively. In contrast, the proposed alternative would cause the imposition of multiple tax burdens

upon businesses based upon individual states' interpretation of what constitutes sufficient economic contacts with the taxing jurisdictions - without any corresponding benefit afforded those companies, and with a real cost in terms of their potential to expand.

Endorsement of the decisions of the West Virginia Supreme Court of Appeals and the New Jersey Supreme Court would not only change the law, but would do damage to the fundamental notions of federalism that underlie our system of government. Permitting one state to tax income based upon activities occurring beyond its geographic borders would encroach upon the sovereignty of other states contrary to the intent of the Framers.

The new proposed basis for state income taxation would be particularly onerous for small businesses. Many of these companies lack the resources either to comply with or to effectively object to the patchwork governance of their affairs that would inevitably result. A rule that increases costs and limits the growth opportunities for this essential sector of our national economy runs counter to good tax and economic policy as well as the Constitution. The effects of such a rule will only intensify as our economy becomes more focused upon the provision of information and services.

This Court should grant review in both these cases to confirm the continuing vitality of its established precedents delineating the limits upon the states' income taxing authority, to end a growing burden upon interstate commerce, and to restore clarity to this important area of law.

ARGUMENT

I. The Business Community Has Long Relied upon the Physical Presence Requirement, Which Has Been a Touchstone of this Court's Commerce Clause Jurisprudence Regarding State Taxation.

Lawyers and tax professionals have long advised business clients concerning state tax liability upon the basis of the physical presence rule. Reliance upon the rule has been entirely justified based upon this Court's well-established precedents. As the American Bar Association, through its Section of Taxation's State & Local Tax Committee, recently observed: "Because the Supreme Court has never formally distinguished a different nexus standard under the Commerce Clause for the two categories of taxes (income-type taxes and sales and use type taxes), most interested parties logically took this to mean that physical presence was required for both and business decisions were made accordingly." American Bar Association, Section of Taxation, *Draft White Paper on Business Activity Taxes and Nexus* 25 (Jan. 15, 2007), http://abanet.org/tax/committees/TX331000/abawhitepaper011507.pdf.

Indeed, this Court has not decided a single case upholding a state tax of any sort without some degree of in-state physical presence by the taxpayer. Permitting states to deviate from this rule now would overturn the settled expectations brought upon by the Court's precedents. This Court "ought not visit economic hardship upon those who took [it] at [its] word . . . . [R]eliance upon a square, unabandoned holding of the Supreme Court is always justifiable." *Quill*, 504 U.S. at 316-17 (Scalia, J., concurring).

The Commerce Clause confers upon the federal legislature the exclusive power to regulate commerce "among the several States." U.S. Const. art. I, § 8, cl. 3. The grant of this power to the national government was a purposeful attempt by the Framers to remedy one of the primary shortcomings in the previously prevailing system. As Chief Justice John Marshall observed, "It may be doubted whether any of the evils proceeding from the feebleness of the federal government [under the Articles of Confederation], contributed more to that great revolution which introduced the [constitutional] system, than the deep and general conviction, that commerce ought to be regulated by Congress." *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 446 (1827).

The Articles of Confederation permitted each state to act as a sovereign entity in levying taxes as it saw fit. The intent of the Framers in drafting the Commerce Clause was to eliminate the devastating effects of the state tax "wars" that resulted from this earlier system. *See Quill*, 504 U.S. at 312. The "dormant" or "negative" implication inherent in this grant of federal power is a prohibition against states undertaking any act that unduly burdens interstate commerce. It has long been settled that the dormant Commerce Clause limits state power over the taxation of interstate commerce. *Webber v. Virginia*, 103 U.S. 344, 350 (1880).

In the modern era, this Court has uniformly defined limits of state authority to tax interstate commerce based upon evidence of the taxpayer's physical presence in the state. The Court's precedents have not varied depending upon whether the case concerned a duty to collect sales and use taxes or the imposition of an income-based tax.

Thus, *Miller Brothers Co. v. Maryland*, 347 U.S. 340 (1954), established that an out-of-state store selling goods to residents with ***no in-state physical entry or presence*** could not be required to collect use taxes. Applying a due process analysis, the Court looked for "some definite link, some minimum connection, between [the] state and the person, property or transaction it seeks to tax." *Id.* at 344-45. Finding no such link or connection (despite the presence of consumers for the seller's goods), the Court rejected imposition of the burden upon interstate commerce.

The Court looked through the same lens of physical presence in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), in holding that an out-of-state business's net income earned through interstate commerce may be subjected to taxation if, *inter alia*, the tax is properly apportioned to the company's activities ***within the state***. The taxpayer's local physical presence created the link or connection (referred to in later cases as "substantial nexus") required to support income taxation of the interstate activity. *Id.* at 454-55. Federal legislation has since fortified this physical presence requirement.[2]

Bellas Hess made it explicit that ***actual physical presence*** is the *sine qua non* for state taxing authority. In this decision, the Court rejected the state's imposition of

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[2] Shortly after *Portland Cement*, Congress passed P.L. 86-272, 15 U.S.C. § 381 (1959), which further curtailed state power to impose a net income tax upon a seller of tangible personal property even if actual physical presence exists by requiring the seller's in-state activities to exceed the mere solicitation of business. The statute is silent as to intangible property or services, the issue in these cases.

a duty to collect use taxes where a mail-order retailer's only connection with the state was through solicitation and the shipment of goods to consumers by common carrier and the mail. 386 U.S. at 758. The Court held that the collection duty created an impermissible burden upon the free flow of interstate commerce because the seller had no physical presence such as retail outlets or salespeople.

Complete Auto synthesized this Court's earlier holdings and articulated the controlling four-part test for assessing the validity of ***any*** state tax imposed upon interstate commerce. The Court explained that it would examine not the type but the practical effect of the tax to determine whether it is "applied to an activity with a ***substantial nexus*** with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." 430 U.S. at 279 (emphasis added). The taxpayer in *Complete Auto* was an out-of-state trucking company hired to transport cars to local dealers after their shipment by rail into the taxing state. This Court sustained the imposition of a business privilege tax because, *inter alia*, the business activity, which was conducted in-state, bore a substantial nexus with the state that justified the tax. *Id.* at 287.

Applying the *Complete Auto* test in *Quill*, this Court emphasized that physical presence is a necessary element in defining the limit of state taxing authority over an out-of-state business. *Quill* reaffirmed the *Bellas Hess* rule that in-state physical presence is required before a mail order company may be compelled to collect a use tax, and rejected the notion that the remarkable growth of the mail order industry

and advances in technology had rendered the bright-line physical presence rule "obsolete." 504 U.S. at 310.

In retaining the holding of *Bellas Hess* in *Quill*, this Court observed that it had "never intimated" in its prior decisions a desire to reject the physical presence requirement, and that "all of these cases involved taxpayers who had a physical presence in the taxing State." 504 U.S. at 314. While the Court abandoned the physical presence requirement as necessary to satisfy the minimum contacts inquiry of the Due Process Clause, it expressly reaffirmed the centrality of that requirement to the more exacting Commerce Clause analysis. *Id.* at 315 ("[s]uch a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes").

Numerous other decisions underscore that this Court has always considered evidence of physical presence as the baseline for determining a substantial nexus with the taxing jurisdiction:

- In *D.H. Holmes Co. v. McNamara*, 486 U.S. 24 (1988), the Court affirmed the imposition of a use tax collection duty based upon the value of merchandise catalogs mailed from out of state because the producer of those catalogs had a significant in-state presence, including thirteen stores and over $100 million in annual sales.

- In *Tyler Pipe Industries v. State Department of Revenue*, 483 U.S. 232 (1987), the Court affirmed the imposition of a gross receipts tax where the business had an in-state independent contractor sales agency.

- In *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977), the Court held that maintaining two offices with employees in the taxing state, even if unrelated to the income generating activity, established a sufficient nexus to support the duty to collect sales and use taxes.

- In *Standard Pressed Steel Co. v. Washington Department of Revenue*, 419 U.S. 560 (1975), the Court looked to physical presence in affirming the imposition of a gross receipts tax where the business had an in-state salaried employee servicing an in-state customer.

- In *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), the Court sustained the imposition of a use tax collection duty where the business had a physical presence of ten salesmen conducting continuous in-state solicitation and forwarding resulting orders back to the home state.

The question here, of course, is whether the West Virginia Supreme Court of Appeals, the New Jersey Supreme Court, and certain other state courts are correct that the physical presence standard may be abandoned in non-sales and use tax cases. The answer to that question must be "no" because this Court has never deviated from requiring a showing of physical presence even in cases involving taxes based upon income. Indeed, to hold that the form in which a state levies its tax has any meaningful role in the Commerce Clause analysis is to negate the "practical effect" inquiry that the Court adopted in *Complete Auto*. There is simply no constitutional basis for imposing an income-based tax burden without requiring a showing

of physical presence. Any distinction among the various tax classifications is semantic rather than legal.

If anything, a more, rather than less, substantial nexus standard should be required for income-based taxes because sales and use taxes merely impose a collection duty upon the business, whereas income-based taxes are actually borne by the business. *See Nat'l Geographic*, 430 U.S. at 558; Tun-Jen Chiang, *State Income Taxation of Out-of-State Trademark Holding Companies*, 70 U. Chi. L. Rev. 1533, 1541 (2003) ("Since one goal of the dormant Commerce Clause is to ensure that each state taxes only its 'fair share' of interstate commerce, the method of taxation that would be more effective in placing the burden on out-of-state companies should face stricter, not looser, scrutiny.").

Moreover, as a practical matter, compliance with an income-based tax is at least as burdensome upon a business's ability to engage in interstate commerce as compliance with a duty to collect sales and use taxes. In *Quill*, this Court recognized that the duty to collect sales and use taxes placed a sufficient burden upon interstate commerce to warrant review and a reaffirmation of the physical presence standard. 504 U.S. at 313-14. The Court should grant review and reverse here for the same reasons that it acted in *Quill*.

In short, based upon the reasonable reliance that businesses have placed upon the *Bellas Hess* rule, the Court should take this opportunity to dispel any question as to the validity and application of this rule by granting the petitions and holding expressly that the physical presence requirement governs the taxation of income generated through interstate commerce.

II. The Alternative "Economic Presence" Test Proposed by Certain State Courts Has No Constitutional Basis, Is Unworkable as a Matter of Good Tax Policy, and Unduly Burdens Interstate Commerce.

In place of the physical presence requirement for the imposition of state income tax liability, the West Virginia Supreme Court of Appeals and the New Jersey Supreme Court (like certain other state courts) have endorsed the so-called "economic presence" approach, which the West Virginia court defined as involving "an examination of both the quality and quantity of the company's economic presence." *MBNA*, 640 S.E.2d 226, 234 (quotation omitted); *see also Lanco*, 908 A.2d 176, 176 (approving the reasoning of the New Jersey Superior Court, 879 A.2d 1234, 1240-42). As explained in *MBNA*, "purposeful direction towards a state is analyzed as it is for Due Process Clause purposes, and the Commerce Clause analysis requires the additional examination of the frequency, quantity and systematic nature of a taxpayer's economic contacts with a state." 640 S.E.2d at 234 (quotations omitted).

The West Virginia Supreme Court of Appeals opined that "a significant economic presence test is a better indicator [than physical presence] of whether substantial nexus exists for Commerce Clause purposes." 640 S.E.2d at 234. This Court, however, has never relied solely upon evidence of an "economic presence" to establish a substantial nexus. Any such reliance would flout long-established jurisprudence.

The substantial nexus requirement is not an examination of minimum contacts to satisfy due

process. Rather, as this Court has made clear, it is "***a means for limiting state burdens on interstate commerce.***" *Quill*, 504 U.S. at 313 (emphasis added). The analysis of the state courts adopting an "economic presence" standard is fundamentally flawed because it improperly co-mingles the Court's Due Process Clause test and Commerce Clause test.

The question for Commerce Clause purposes is not simply whether exposing an out-of-state business to a state's taxing power would be unfair. Instead, the question is whether the business activity in question has a sufficient connection with the state so that the imposition of a tax by the state would not unduly burden interstate trade. The "economic presence" standard merely reaches the due process inquiry and goes no further. It therefore must be rejected.

As this Court recognized in *Quill*, physical presence is a "bright-line rule [that] furthers the ends of the dormant Commerce Clause." 504 U.S. at 314. The test is equitable, simple to comprehend, and easy to enforce. It also favors economic growth: a business that reports and pays taxes in fewer states spends less money complying with tax laws and litigating their application, and thus has more money to invest in labor and capital. Additionally, the test permits a business to determine with confidence, before entering a particular state, whether it will be subject to taxation there and is willing to incur the associated costs (such as the likely need to keep multiple records, meet multiple filing requirements, and engage in multiple interactions with regulators). Settled expectations foster investment, *Quill*, 504 U.S. at 316, and our national economy benefits from the stability of a bright-line rule.

In contrast, the so-called economic presence "test" is no test at all. The standard adopted by the West Virginia Supreme Court of Appeals is particularly amorphous. It arguably would permit the imposition of income and similar taxes merely upon evidence of consumers for a business's services, the derivation of income in any form, or even advertising directed at a state where the business has no tangible physical presence.

An "economic presence" standard would be especially burdensome as applied to small businesses. This is perhaps best demonstrated by analyzing the potential application of this proposed basis for income taxation to the types of operations in which GPCC and CCSNJ members engage. Consider these scenarios:

1. A professor from the University of Pennsylvania recognized as the nation's leading state and local government financing authority forms a consulting company ("Expert") to provide services to state and local governments throughout the United States. Expert never performs any services outside Pennsylvania and has no physical presence in any other state. All communications between Expert and its clients are electronic. Expert's only nexus with states other than Pennsylvania is that its clients are located within the other states. Based upon an "economic presence" standard, in addition to Pennsylvania where Expert maintains physical presence, all other states where Expert has clients could reasonably argue that Expert "systematically" and "purposefully" exploits their markets, and thus has a sufficient nexus for them to impose a tax on Expert's income from those clients.

2. A small businessman in New Jersey owns a car wash ("Car Wash") that advertises on Philadelphia radio and television stations and in Philadelphia newspapers that its rates for a car wash, detailing, and many other services are the lowest in the region. Car Wash has no physical presence in Pennsylvania. Thousands of Pennsylvania motorists pass Car Wash each weekend when headed east to the New Jersey beaches and Atlantic City, and it earns significant income each year from these Pennsylvania residents. Based upon an "economic presence" standard, Pennsylvania could reasonably argue that Car Wash's "systematic" and "purposeful" efforts directed at enticing Pennsylvania residents to purchase its services provide a sufficient nexus for Pennsylvania to tax the income derived from them.

3. A neurology practice at a leading hospital in Wilmington, Delaware ("Doctors") regularly engages in remote "telemedical" examinations of stroke patients who are brought into emergency rooms in rural hospitals throughout the mid-Atlantic United States. The emergency room physicians electronically transfer patient CT scans and other data to Doctors for review on Doctors' computer in Delaware. Doctors and the emergency room physicians then confer by telephone or by videoconferencing link regarding diagnosis and treatment. Despite Doctors' lack of physical presence in any state but Delaware, all of the states where Doctors' "telepatients" are located could reasonably argue based upon an "economic presence" standard that Doctors' "systematic" and "purposeful" direction toward those states provides a sufficient nexus for income tax liability.

Each of these scenarios involves an expansion of state taxing jurisdiction well beyond its traditional bounds. The corresponding burden upon interstate commerce will only increase as our national economy becomes more dependent upon the provision of information and services as opposed to manufacturing, and as more states see the potential to expand their tax bases by adopting "economic presence" as the purported basis for their income taxing authority.

The West Virginia Supreme Court of Appeals and the New Jersey Supreme Court are the latest state courts to permit this drastic impediment to free trade.[3] The time has come for this Court to intervene and to resolve the growing conflict between these courts and other state courts that recognize the centrality of the physical presence rule in assessing income-based taxes.[4]

Supporters of an "economic presence" standard argue that businesses benefit from the existence of a viable economic market in the states in which they have

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[3] The pioneer case was *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C.), *cert. denied*, 510 U.S. 992 (1993). *See also A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *certif. denied*, 611 S.E.2d 168 (N.C.), *cert. denied*, 126 S. Ct. 353 (2005); *K-Mart Properties, Inc. v. Taxation & Revenue Department*, 131 P.3d 27 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22 (N.M. 2005).

[4] *See Guardian Indus. Corp. v. Dep't of Treas.*, 499 N.W.2d 349 (Mich. App. 1993), *appeal denied*, 512 N.W.2d 846 (1994); *Gillette Co. v. Dep't of Treas.*, 497 N.W.2d 595 (Mich. App. 1993), *appeal denied*, 519 N.W.2d 156 (Mich. 1994), *cert. denied*, 513 U.S. 1003 (1995); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.2d 831 (Tenn. Ct. App.), *appeal denied*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000), *cert. denied*, 531 U.S. 927 (2000); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000).

customers and thus should be expected to pay income taxes there. This argument proves that "economic presence" is nothing more than a reward of out-of-state tax money for states that do what they ought to do in our integrated national economy: attract the provision of goods and services for the benefit of their residents. The taxation of non-residents is not easily restrained by political processes within the taxing state, and a state has every incentive to export its tax burden and interpret its laws aggressively to reach as many out-of-state taxpayers as possible.

Physical presence, by contrast, provides a far more reliable basis for determining that a business has obtained benefits from a state as required by the fourth prong of *Complete Auto*, 430 U.S. at 279. This test ties the taxes paid by a business to the communities within which it employs labor and expends capital, and thus actually utilizes education, transportation, public safety, and other services. This Court should grant the petitions to reaffirm for the benefit of state courts the continued vitality of the physical presence rule and its applicability to income as well as sales and use taxes.

III. The Physical Presence Requirement Bolsters Federalism and Reinforces the Integrity of State Sovereignty.

One of the main foundations of our federalist system of government is that the power to regulate beyond individual states' borders rests not with those states but with Congress. An "economic presence" standard would sanction extraterritorial taxation in each scenario posed above and thus violate perhaps the most fundamental principle of our Constitution.

As explained *supra*, the Commerce Clause specifically rejected the approach of the Articles of Confederation, which permitted states to impose taxes beyond their geographic boundaries and burden the flow of commerce. In this Court's words, "[t]he very purpose of the Commerce Clause was to create an area of free trade among the several States. That clause vested the power of taxing a transaction forming an unbroken process of interstate commerce in the Congress, not in the States." *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327, 330-31 (1944); *see also Allied-Signal, Inc. v. Dir., Div. of Tax.*, 504 U.S. 768, 777-778 (1992) ("In a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation.").

Our system of government reserves certain authority to the States. Indeed, respect for the sovereign power of each State over its territory is essential to maintaining the federalist balance, lest the powers of the national government be permitted to encroach too far into local activity. *E.g., United States v. Lopez*, 514 U.S. 549 (1995).

However, state sovereignty can only be respected when state territorial boundaries retain their integrity. *See* The Federalist No. 22 (Alexander Hamilton) ("The interfering and unneighborly regulations of some States, contrary to the spirit of the Union, have . . . given just cause of umbrage and complaint to others . . . ."). This Court has consistently reaffirmed the critical function served by states' geographic borders in marking the outer reaches of state power. *See, e.g., State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 421

(2003); *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 569-71 (1996); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 821-23 (1985).

States' physical bounds are effectively erased by out-of-state taxation that is justified on the basis of an "economic presence." As the above scenarios illustrate, virtually every business that sells services to out-of-state consumers arguably has such a presence in the states where its customers reside. Thus, this standard would make entities "fair game" for income taxation without any reference to the state boundaries within which they operate, thereby rendering geographic borders meaningless as limitations of state power. If one state can expand the territorial reach of its taxing authority, by definition it is regulating activity that is occurring within the territory of another state.

In contrast, the physical presence test promotes respect for geographic borders by limiting the exercise of state authority over out-of-state businesses to those entities that engage in activity, through some form of physical presence, within the state's bounds. Absent the restrictions imposed by physical presence, there is little reason to believe that states will continue to respect the traditional bounds of their sovereignty or the sovereignty of other states in the Union.

While commerce today is frequently conducted without regard to borders, the proper balance of power in our federalist system of government continues to depend upon the integrity of those borders. If states are permitted to assert authority beyond their boundaries, foreign governments will undoubtedly

claim the same right. Since the latter scenario is clearly unacceptable, the former ought not be permitted.

In short, an "economic presence" standard is the equivalent of giving each state nationwide taxing authority over any business that generates income from within the state, and thus an improper reversion to the system of the Articles of Confederation. This Court should take this opportunity to instruct that, regardless of the type of tax states wish to impose, economic presence without an accompanying showing of physical presence is constitutionally insufficient, as a matter of law, for Commerce Clause purposes.

CONCLUSION

For the foregoing reasons, this Court should grant the petitions and reverse the decisions below.

Respectfully submitted,

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LANCO, INC.,

Petitioner,

v.

TAX COMMISSIONER OF THE STATE OF NEW JERSEY,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of New Jersey

BRIEF OF *AMICUS CURIAE* THE SHERWIN-WILLIAMS COMPANY IN SUPPORT OF PETITIONER

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STATEMENT OF INTEREST OF *AMICUS CURIAE*[1]

The Sherwin-Williams Company ("Sherwin-Williams") is an Ohio Corporation in the business of manufacturing and retailing paint and paint-related products. Sherwin-Williams is actively engaged in interstate commerce, doing business in all 50 states. As such, Sherwin-Williams relies on this Court's interpretation of the Commerce Clause of the United States Constitution when making business decisions and otherwise conducting itself in the interstate marketplace.

As this Court noted in *Quill Corp. v. North Dakota*, the law in the area of state tax nexus is in something of a quagmire. 504 U.S. 298, 315 (1992). This is especially true in the context of state income tax nexus. Fifteen years ago in *Quill*, this Court reaffirmed the long-standing rule that a business must be physically present before a state may impose the burden to collect its sales tax on that business. *Id.* at 317-18. Businesses relied on *Quill* and the fact that this Court has never held that a state may impose its tax on a business without physical presence. Businesses reasonably believed the physical presence rule applied to all types of state tax and made decisions consistent with this reasonable understanding. Some state courts and state departments of taxation agreed,[2] while other states

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[1] The parties have consented to the filing of this brief.

Counsel for a party did not author this brief in whole or in part. No person or entity, other than the *Amicus Curiae*, its members, or its counsel made a monetary contribution to the preparation and submission of this brief.

[2] For instance, in 2000, the Tennessee Supreme Court affirmed a lower court decision holding the physical presence rule applies in the context of the income tax. *JC Penney Nat'l Bank v. Johnson*, Comm'r of Revenue, No. M1998-00497-SC-R11_CV (Tenn. May 8, 2000) (per

(Continued on following page)

saw an opening to increase revenue based on this Court's dicta in *Quill*.

Starting with South Carolina, many state courts, leaping a few logical steps, adopted the theory that *Quill* applies only in the context of the sales tax. *See Geoffrey, Inc. v. SC Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993); *see also, e.g., A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. 2004); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005). These states, seizing upon dicta in *Quill*, concluded they could impose their income taxes on businesses with absolutely no physical presence within their borders.[3]

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curiam). The New Jersey Tax Court, in this case, similarly held that the physical presence rule applies in the context of the income tax only to be later reversed by the state's appellate court, whose decision was later affirmed by New Jersey's highest court. *Lanco, Inc. v. Director, Div'n of Tax'n*, 21 N.J. Tax 200 (2003).

[3] For example, the West Virginia Supreme Court of Appeals recently held:

> [T]he Supreme Court appears to have expressly limited *Quill's* scope to sales and use taxes. First, the *Quill* Court noted that "[although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." *Quill*, 504 U.S. at 314, 112 S.Ct. at 1914. Also, the Court commented that "although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes." *Id.*, 504 U.S. at 317, 112 S.Ct. at 1916. We believe that a reasonable construction of this language clearly implies that *Quill* applies only to sales and use taxes and not to other types of state taxes.

(Continued on following page)

Businesses like Sherwin-Williams relied on *Quill* and its ancestors in the absence of a separate ruling from this Court on state income tax nexus. When states impose their income tax on corporations with no physical presence, the consequences are often extremely and inappropriately harsh. This climate of uncertainty and potential harshness prevents multistate businesses like Sherwin-Williams from confidently broadening the scope of their interstate activities. Therefore, not only is it in Sherwin-Williams' interest, but also the free flow of interstate commerce necessitates this Court clarify that the bright-line physical presence rule applies in the context of the state income tax.

SUMMARY OF ARGUMENT

In *Quill*, this Court held that the bright-line physical presence rule furthered the ends of the Commerce Clause, declaring "[u]ndue burdens on interstate commerce may be avoided . . . in some situations, by the demarcation of a discrete realm of commercial activity that is free from interstate taxation." 504 U.S. at 314-15. This Court further explained that a bright-line physical presence rule establishes the states' taxing authority and consequently reduces litigation related to that authority. *Id.* at 315.

This is exactly why a bright-line physical presence rule in the context of state income tax nexus is critical to a multistate businesses like Sherwin-Williams. There is no justification for a bright-line physical presence rule only in

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Tax Comm'r of State v. MBNA America Bank, N.A., 640 S.E.2d 226, 232 (W.Va. 2006).

the context of the sales or use tax. Despite what some state courts and academics claim, the reality from the perspective of multistate businesses is that the complexities and compliance demands of income tax laws require greater certainty and a clearer nexus rule than sales and use tax laws demands.

In addition, more is at stake for multistate businesses when a state directly imposes its income tax on those businesses versus when a state imposes on such businesses the mere duty to collect sales or use tax from customers for remittance to the state. The uncertainty resulting from the lack of a bright-line physical presence rule has created a harsh environment in which multistate companies are potentially subject to unjustifiably huge penalties and back income tax liabilities for periods extending back many years.

Moreover, dramatic changes in the climate of interstate commerce occurring since the *Quill* decision in 1992 have raised the stakes even higher. Since *Quill* was decided, the nation has experienced several financial accounting scandals and a dramatic rise in attention to corporate financial accountability. Along with Congressional mandates like Sarbannes-Oxley, the Financial Accounting Standards Board ("FASB") has issued rules for corporate accounting increasing the stakes associated with accounting for income taxes on corporate financial statements. FASB Statement No. 109, *Accounting for Income Taxes* and its related interpretation, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), relate to the recognition of tax benefits and liabilities on a company's financial statement. FIN 48 magnifies the ill effects of the ambiguity surrounding the Commerce Clause as it applies to state income tax nexus.

As *Quill* explains, a bright-line physical presence rule allows corporate taxpayers to precisely determine whether a state may impose a tax on them and if so, to what extent the state may tax them. This principle does not only mandate a bright-line physical presence rule in the case of state sales and use tax. Because of the complexities of income tax laws, the burdens of compliance, and the high stakes involved, a bright-line physical presence rule is absolutely critical in the case of state income tax nexus.

ARGUMENT

I. The Burdens of Compliance with and the Complexity of State Income Tax Laws Necessitate a Bright-Line Physical Presence Rule for State Income Tax Nexus.

While the New Jersey court in this case maintains that there are "'important distinctions between sales and use taxes [as compared to] income and franchise taxes that makes the physical presence test . . . inappropriate as a nexus test' for taxation beyond the use and sales taxes," in fact, the opposite is true. *See Lanco, Inc. v. Director, Div. of Tax'n*, 879 A.2d 1234, 1240 (N.J. Super. A.D., 2005) (quoting *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194) (alterations in original). Differences between the burdens of complying with sales tax laws versus the burdens of complying with income tax laws do not warrant a bright-line physical presence rule for one and not the other. If anything, the compliance burdens associated with state income tax laws, financial accounting rules, and investor reliance on companies' effective income tax rates reporting dictate that it is even more important to have a bright-line unambiguous physical presence rule in the case of the

income tax than it is to have such a rule in the context of the sales tax.

Sherwin-Williams is on the front lines of state tax law compliance, working every day and devoting an entire department of the company to compliance with both sales tax laws and income tax laws, as well as many other types of tax. Sherwin-Williams has first-hand knowledge that complying with state income tax laws is more burdensome than complying with any other type of tax law and income tax laws are far more complex than any other type of tax law, including sales and use tax laws.

Some State courts and academics have focused on the number of returns rather than the complexity of compliance with the respective state laws and generally grossly underestimate the amount of jurisdictions to which multi-state companies must file income tax returns. A typical state court justification for concluding that compliance with state income tax laws is less onerous than compliance with state sales tax laws is because "state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, [but] a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates." *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194 (N.C. App. 2004); *see also, e.g., Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 234 (W.Va. 2006); Cory D. Olson, Comment, *Following the Giraffe's Lead – Lanco, Inc. v. Director, Division of Taxation Gets Lost in the Quagmire That Is State Taxation*, 6 MINN. J. L. SCI. & TECH. 789, 813-14 (2005).

This is not the reality for multi-state businesses like Sherwin-Williams. In many states, localities are permitted to impose their own income taxes on corporations.[4] Additionally, many income-taxing jurisdictions require multiple income tax filings each year, as well as estimated periodic.[5] Also, when a corporate taxpayer needs more time to file a return it generally must file an application for an extension. Sherwin-Williams files returns in approximately 170 state and local income tax jurisdictions on behalf of itself and its subsidiaries. As such, over the course of a typical year, the Sherwin-Williams' Tax Department files approximately 1700 income tax returns, estimated periodic payments, or applications for extensions to file returns.

Another typical argument that compliance with state sales tax laws is more onerous than compliance with state income tax laws is that the differences are less complex between state and local income tax laws across jurisdictions than the differences in sales tax laws across jurisdictions. *See, e.g.,* John A. Swain, *State Income Tax Jurisdiction: A Jurisdictional and Policy Perspective*, 45 WM. & MARY L. REV. 319, 368 (2003) (arguing "several key features of state corporate income taxes suggest that they are significantly less burdensome" to comply with than state sales tax laws). From Sherwin-Williams' perspective, this is simply not true.

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[4] Sherwin-Williams' home city of Cleveland, Ohio, for example, imposes an income tax on the company as do over 50 municipalities in the Greater Cleveland area alone. CLEVE. CITY INCOME TAX ORD. § 191.0101 (2004).

[5] Alabama and Idaho are just two of many examples of income-taxing jurisdictions requiring quarterly filing. ALA. ADMIN. CODE 810-3-82-.02 (2006); IDAHO CODE § 63-3036A (2001).

The difference between state sales tax laws generally is limited to exemptions, rates, and the timing and manner of reporting. On the other hand, not only do jurisdictions vary in their income tax rates and timing and manner of income tax reporting, there are also countless other differences adding to the complex web of state and local income tax laws. State and local laws differ, for example, in what items qualify as non-business income, as well as allowable deductions, credits and depreciation methods. The amount of time and resources spent researching and collecting data necessary to claim certain state or local deductions and credits alone can be staggering.[6]

Additionally, some states require combined reporting, a single return for all affiliated corporations, while others permit each corporation to file a separate return. Further complicating matters, some combined reporting states require all domestic and foreign affiliates file a single return, while others only require domestic affiliates file a single return. Also, each state has its own formula for calculating the amount of income allocable to it, known as an apportionment formula. Different states may use a different combination of three factors in their apportionment formulas: sales, payroll, and property. Some states

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[6] One employee in the Sherwin-Williams Tax Department estimates he spent 90 hours annually working to comply with the requirements for claiming the Ohio Refundable Jobs Credit, ORC. ANN. § 122.17 (2006). He spends this time coordinating with other departments within Sherwin-Williams, creating databases of information, sorting through documents, and researching changes to the required form and manner of submission of the information. According to this employee, he spends a similar amount of time working on compliance with the requirements of income tax credits for other states.

use all three, some states use two, and some one. States also differ in what items are includable in each factor.

As a result of this greater complexity, Sherwin-Williams' Corporate Tax Department devotes significantly more of its resources to state income tax law compliance versus compliance with state sales tax laws. Sherwin-Williams' Tax Department employs four accountants who devote their entire time on the job to sales tax law compliance. Comparatively, Sherwin-Williams' Tax Department employs seven accountants who devote their entire time on the job to income tax compliance.[7]

The only reason Sherwin-Williams needs four accountants for sales tax is the volume of returns, since sales tax returns are relatively uniform. Conversely, even though there are fewer returns to prepare, Sherwin-Williams needs seven income tax accountants to handle the complexity of income tax returns. Further illustrating the point, the Sherwin-Williams' income tax accountants are employed at a higher grade level than its sales tax accountants: Sherwin-Williams Tax Department spends 25% of its salary budget on income tax accountant salaries, while spending only 12.5% of its salary budget on sales tax accountant salaries.

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[7] The income tax accountants split their time between state and federal income taxes, spending the majority of time working on strictly state issues. It is worth noting that much of the work these accountants do related to federal income taxes is also applicable to state taxes in some way, as many states base at least some of their income tax laws on federal income tax laws. Nebraska, for example, follows the Internal Revenue Code's approach to interest deduction, although with minor modifications. NEB. REV. STAT. § 77-2716 (2007).

Besides accountants, the Sherwin-Williams Tax Department employs five attorneys who spend the vast majority of their time addressing state tax issues addressing income tax issues. The complexity of state income tax law might be best evidenced by the fact that the Sherwin-Williams Tax Department spends a whopping 94% of its state tax litigation budget on litigating income tax issues, while it allocates merely 6% on sales tax issues.

II. The Stakes Are Higher for Multistate Businesses When States Directly Impose Income Taxes on Them Than When States Impose the Duty to Collect Sales or Use Tax on Them, Necessitating a Bright-Line Physical Presence Rule for State Income Tax Nexus.

Besides the greater complexities of and burdens of compliance with state income tax laws, multistate businesses have more at stake when a state asserts nexus to impose a tax on the businesses own income than these businesses have at stake when a state imposes the duty to collect the sales and use tax from their customers. First, in many states, businesses are reimbursed a percentage of the sales tax collected from their customers as compensation for the burdens related to complying with sales tax laws. *See, e.g.,* FLA. STAT. § 212.12(1) (2007) (allowing businesses to retain a percentage of the sales or use tax it collects). Businesses must bear the cost of the burdens related to complying with income tax laws themselves.

Second, businesses bear the cost of the income tax out of their own capital, while merely remitting funds they collect from customers to pay the sales or use tax. Accordingly, a corporation's income tax expense is deducted from its overall earnings while amounts remitted as sales and

use taxes are not. This is of particular importance to multistate businesses like Sherwin-Williams, because shareholders and other investors generally gauge a corporation's health by how much that corporation earns per share.

Shareholders and investors are concerned about a corporation's state income tax expense because that corporation's effective tax rate, the amount of recognized tax expense related to the income earned in a given year,[5] effects its earnings per share: the more income taxes a corporation is expected to pay per dollar of earnings the lower the earnings per share. Thus, shareholders and investors benefit from a precisely calculated effective tax rate because such gives them confidence in their ability to gauge the health of that corporation.

Besides benefits related to investor confidence, corporations benefit from a precisely calculated effective tax rate because such allows a corporation to know more precisely how much capital it will have available for investment, dividends, pension contributions, and salaries, as well as how its shares are priced on the public market. Lenders rely on this information to determine the corporations debt-rating.

Third and most importantly, multistate businesses like Sherwin-Williams have long relied on *Quill* and its ancestors in the absence of a separate ruling for state income tax nexus. Before a state jumped on the economic nexus bandwagon, businesses without physical presence in that state had no reason to file an income tax return in

[5] The effective tax rate is calculated as the year's recognized tax expense divided by the year's profits before tax.

that state. This fact is of great consequence to these businesses because if a business does not file a return the statute of limitations does not begin to run in most jurisdictions. *See, e.g.,* ILCS Chapter 35 § 5/905(C) (2006); N.J. REV. STAT. § 54A:9-4(C)(1)(A) (2006).

As a result and despite these businesses' reasonable reliance on *Quill* and its ancestors, such businesses may be liable for unquantifiable back taxes and interest attributable to long ago tax years. Along with back taxes and interest, states will likely also assess penalties for failure to file a return and for failure to timely pay income taxes due. These penalties are generally calculated as a percentage of the state-claimed back tax liability. *See, e.g.,* HAW. REV. STAT. § 231-39 (2007) (imposing a penalty of as much as 25% of the balance due, for the late filing of a corporate income tax return); ME. REV. STAT. ANN. 36 § 187-B(1)(C) (imposing a penalty of as much as 100% of the assessed taxes for the late payment of corporate income taxes).

Thus, under the current climate of ambiguity, multistate businesses are unjustifiably threatened by constantly compounding tax, interest, and penalty liability. A bright-line physical presence rule would remove this threatened avalanche and would consequently facilitate the interstate growth of multistate businesses like Sherwin-Williams.

III. The Recent Dramatic Rise in Attention to Corporate Financial Accountability Necessitates a Bright-Line Physical Presence Rule for State Income Tax Nexus.

In today's business climate, more than any other time, a bright-line physical presence rule for income tax nexus is

critical to the free flow of interstate commerce. Now, more than ever, multistate businesses must have the ability to determine their income tax expense as precisely as possible. To address recent financial reporting scandals and to better ensure that corporate financial statements are worthy of investors' reliance,[9] Congress, the SEC, and FASB have increased their regulation and scrutiny of financial reporting. A bright-line physical presence rule would further the aims of Congress, the SEC, and FASB in the area of financial accountability by facilitating a more precise determination of multistate corporations' state income tax expenses and effective tax rates, while the current uncertainty surrounding state income tax nexus thwarts their aims.

Of particular relevance is a recent FASB pronouncement, FIN 48. By way of background, FASB is charged with promulgating corporate accounting rules that are binding on businesses like Sherwin-Williams. One such rule is FASB Statement No. 109 *Accounting for Income Taxes* ("FAS 109"). FAS 109 provides guidelines for reporting the estimated amount of income taxes payable or refundable in a current tax year. In 2006, FASB clarified FAS 109 by issuing FIN 48 to address problems related to accounting for contingent income tax benefits.

FIN 48 limits the income tax benefits a corporation can recognize on its financial statement to those arising from tax positions "more likely than not" to ultimately be sustained. For purposes of FIN 48, an income tax position

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[9] Shareholders and other investors rely on a corporation's financial information including its reported income tax expense and effective tax rate to measure the health of that corporation.

is more likely than not to be sustained if it has a greater than 50% likelihood of being sustained on audit. The more-likely-than-not standard simply determines whether the benefit may be reported on the financial statement at all. If the benefit does not meet the more-likely-than-not threshold the company may not recognize a single dollar of the benefit on its financial statement.

If the benefit meets the more-likely-than-not standard, the company still will likely not be able to report the entire benefit on its financial report. Instead, the company may only include the portion of that benefit that is more likely than not to be sustained on audit. The company determines the reportable portion through the use of a complicated probability analysis and must make detailed disclosures of its analysis. In most cases, the end result is that companies will be able to report only a fraction of the tax benefits they expect during the tax year.

FIN 48 also requires that a corporation report potential penalties related to its tax positions as a tax liability, off-setting the benefit of that position, unless the corporation meets the statutory requirement for waiver of that penalty. In the context of state tax, this sometimes means that all potential penalties must be included on the financial statement as a liability because there is no statutory provision for waiver of that penalty.[10] This is particularly onerous because under current conditions, as discussed

[10] In Alaska, for example, penalties may only be waived in the discretion of the Department of Revenue or the Attorney General. ALASKA STAT. § 43.05.070 (2006). Therefore, there is no statutory provision for waiver of the penalty and a company must account for all potential Alaska penalties on its financial report.

above, states may potentially impose enormous penalties on corporations with no physical presence within the state.

For these reasons, the ambiguity surrounding the issue of state income tax nexus interferes with corporations' abilities to conduct themselves in the interstate marketplace. The more uncertainty surrounding an income tax position, the less likely it is that a corporation may recognize the benefit from such a position on its financial statement under FIN 48. As a result, the financial statement may reflect lower earnings per share than reality dictates. Combined with the fact that FIN 48 also requires that corporations reserve for potentially enormous penalties resulting from this uncertainty, until the law in this area is clear, corporations will also likely have less available capital for investment. Finally, the potential liability for failure to file and substantial underpayment penalties, alone, is enough for businesses to think twice before expanding operations interstate.

A clearly articulated physical presence rule for state income tax nexus would go a long way to furthering the ends of FIN 48. Such a rule would reduce uncertainty related to multistate businesses' state income tax positions resulting in a more realistic report of multistate corporations' income tax expense, effective tax rate, and earnings per share.

CONCLUSION

For these reasons, The Sherwin-Williams Company respectfully requests that this Court grant Lanco's petition for a writ of certiorari and reverse the decision of the Supreme Court of New Jersey.

Respectfully submitted,

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